LECTURE NOTES ON THE LAW OF CONTRACTS

No. I

ON THE THEORETICAL FOUNDATIONS OF CONTRACT LAW

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> ***"The Law of Contracts may be described as the endeavor of the State…. to establish a positive sanction for the expectation of good faith which have grown up in the mutual dealings of men of average right-mindedness… He who has given the promise is bound to him who accepts it, not merely because he had or expressed a certain intention, but because he so expressed himself as to entitle the other party to rely on his acting in a certain way." Sir Fredrick Pollack***

I. OBLIGATIONS IN GENERAL

a. General

i. **In the Civilian legal tradition, private law is categorized into three major fields of study – *the law of status, the law of things and the law of obligation.* The study of the law of contracts is just an aspect of the law of obligations. This classical distinction is somewhat reflected in the structure and contents of the 1960 Civil Code of Ethiopia.**

ii. **Books One (On the Law of Persons) and Two (On the Law Family and Successions) are essentially the domain of the Law of Status; Book Three (On the Law of Goods) is that of the Law of Things; while Books Four (On Obligations) and Five (On Special**

Contracts) are in the realm of the Law of Obligations.

iii. **The above classification is not in the nature of a water tight compartment as there are many instances whereby a provision in one category may jump into another and vice versa.**

b. **<u>Scope of obligations.</u> In jurisprudence, obligation is that part of the law which creates rights *in personam* as opposed to rights *in rem.* In most cases, obligations arise from the actions of the obligor, either by an act to which he freely consented or by a faulty conduct on his part or on the part of another. An obligation thus denotes acts or forbearances which one is bound to perform in favor of another or refrain from performing in the interest of another.**

c. **<u>Some Accepted Definitions of Obligation*s*</u>**

i. **"A legal bond by which by which one person is constrained towards another to do or not to do something." *Planiol.***

ii. **"A legal bond between two persons in virtue of which one of them is bound, in favor of the other, to do a certain act or to abstain from doing an act so as to create a right over a thing or to transfer the ownership of a thing." *Amos and Walton.***

iii. **"That which a person is bound to do or forebear, … that which constitutes a legal or moral duty and which renders a person liable to coercion and punishment for neglecting it." Black's Law Dictionary.**

d. **<u>Sources of and Parties in Obligations</u>**

i. **Normally, the sources of obligations are the law or the action and/or promise of the holder of the obligation.**

ii. **Those that stem from the actions of the parties are primarily contracts. In other words, such obligations are referred to as contractual obligations.**

iii. **Extra contractual obligations may have the law, the faulty conduct of the obligor and the actions of third parties for whom the obligor is answerable as their sources.**

iv. **In most instances, obligations create a creditor-debtor relationship between the persons bound by them. He who has a claim over another is known as the *creditor,* while he who is liable to the claim of the creditor is called the *debtor.* But we need to examine the corresponding rights and obligations of the parties before stating this party is a creditor and that a debtor. If one takes, a contract of sales, for example, the seller is a creditor regarding payment of the agreed upon price while he is a debtor when it comes to delivering the item sold to the buyer; and vice versa.**

II. THE NEED FOR CONTRACTS

a. **Social interactions. No one can live in a solitary world of his own and this state of affairs calls, among others, the need for creating and fostering economic relationship.**

b. **Division of labour. One cannot be self contained in satisfying all his needs and those of his immediate family. This necessitates an act of bargaining to get the goods and services of others in consideration of discharging some kind of obligation on one's part.**

c. **The necessity of social regulation. As in all other walks of life there may ensue disputes in the course of these interactions – hence bringing society's desire to control and regulate human actions and inactions stemming from these economic relationships.**

The basic features of the relationships have to be defined; the effects thereon need to be spelt out; modalities of creating as well as terminating the relationships must be put in place; and the means of ensuring the rights and obligations of the parties should be devised. Addressing these and other issues is the domain of contract law.

III. MEANING OF A CONTRACT.

a. **Theory of expectation and reliance. It can safely be argued that the law of contract is the most important aspect of the general law of obligations. The expectations engendered by the promisor; and the promisees reliance upon the promise. The primary goal of the State in this regard is to ensure that he who has give a promise to another of his own assent is bound to him who has accepted it since the former has so expressed himself to entitle the other part to rely on the promise.**

b. **Other theoretical Issues*.***

- ***i.*** **A contract is an agreement and, as such, requires the prevalence of two or more parties. It must also be seen to it that there is a meeting of minds of the contracting parties on the subject matter of the agreement. *Intentio obligandi.***
- ***ii.*** **But not all agreements are contracts. A contract essentially differs from other consensual agreements in that the parties express their desire to be bound by their promises. This is not the case in agreements that are not regarded as contracts under the law.**
- ***iii.*** **It can thus be concluded that all contracts are agreements but not vice versa.**
- ***iv.*** **The underlying policy considerations of the law of contracts. (The notion of *Pacta sunt***

***servanda*.** **Freedom of contract v. security in transactions.)**

1. ***The*** **sovereignty of the human will and the sanctity of promise.**
2. **Private autonomy. Parties are delegated by the state to make their own laws with respect to the relationship they intend to create in a contract.**
3. **Needs of business. Once it is affirmed that parties have freely consented to the making of a contract, the full force of the law backs its enforcement for the smooth functioning of business requires so. This is what is known as the theory of *security in transaction.***

c. **Definition of Contract in the Civil Code. Art. 1675. *"A contract is an agreement whereby two or more persons as between themselves create, vary or extinguish obligations of a proprietary nature".* This definition is loaded with important conceptual issues of the law of contract.**

i. ***A contract is an agreement*. See the explanation above on the distinction between an ordinary agreement and a contract.**

ii. ***A contract presupposes the interaction of at least two people.* (Plurality of parties.) It is very unlikely to anticipate a situation whereby one may contract with himself. It is the minds of at least two persons that meet - thereby creating the contract. The persons may be physical (natural); or Juridical, grouping incorporated under the law on whom are bestowed the rights of personality.**

iii. ***A contract is created as between the parties to it.* The principle of *relativity of contract* (*privity* as the British call**

it) has it that no one may be bound by nor claim a right on the basis of a contract to which he is not a party. Present day reality has, however, brought about substantial changes to this general rule.

iv. The subject matter of a contract needs to be proprietary (property related or economic). **Social and moral obligations are not as a rule subject to the law of contract. Nevertheless, it is important to take note of the fact that there are other contracts that entail obligations: - E.g. Agreements to marry; agreement of adoption or agreements for contracting away paternity.**

d. <u>The purpose of a contract may be:</u>

1. **To create obligations – a new deal.**

2. **To vary obligations - improvement or modification of an already existing deal.**

3. **To extinguish obligations – agreement to bring an existing deal to an end.**

IV. <u>CLASSIFICATION AND TYPES OF CONTRACTS:</u>

a. **<u>Classification</u>. Contracts may be classified into different categories depending on their contents, forms or modalities of their preparation. The following are some examples.**

i. **Contracts that entail <u>bilateral and unilateral obligations.</u> These kinds of contracts are sometimes referred to as contracts based on <u>onerous title</u> and those based on <u>gratuitous title</u>.**

ii. **<u>Commutative and aleatory contracts</u>. Contracts with simultaneous performance and those that call for**

performance of some or all of the obligations of one or both parties at some later time.

iii. **<u>Solemn and consensual contracts</u>. Contracts that are required to be made in a special form and those that are not.**

iv. **<u>Contracts of adhesion and contracts of consultation</u>. These are contracts whose contents are drawn up by one party and subscribed to by the other; and those whose contents are outlined by free and express consultation of both.**

v. **<u>General and special contracts</u>. Contracts that are made on the basis of day-to-day business needs and those that are required to comply with special rules of the law for their making and consequences.**

vi. **<u>Valid, voidable and void contracts</u>. Contracts that are made in compliance with all legal requirements and hence duly enforceable; those that are defective but subject to be remedied by the party concerned; and those that are so defective that neither of the parties can bring about their validity.**

b. **<u>Types of contracts under Ethiopian laws.</u> It is in deed very cumbersome to tell the types of specialized contracts that one comes across in the multitude of Ethiopian laws.**

i. **In the Civil Code, for example, we have:**

1. **Contracts relating to the assignment of rights such as contracts of sale, donation or loan.**

2. **Contracts for the performance of services such as contracts of employment, construction**

contracts, contracts for intellectual work or publishing contracts.

3. **Contracts for the custody, use and possession of chattels such as contracts of loan for use, those on bailment or contracts of pledge.**

4. **Contracts that relate to immovable property including contracts for sale, lease or mortgage of immovable property and those on works and labor on those types of properties.**

5. **Administrative contracts and special requirements of formation and effects such contracts.**

6. **Contracts on compromise and arbitral submission.**

ii. In the Commercial Code, we got:

1. **Contracts on sale, hire and mortgage of business.**
2. **Contracts on formation of business organizations.**
3. **Contracts of carriage and insurance.**
4. **Contracts relating to negotiable instruments.**
5. **Contracts on banking transactions.**

iii. In other laws too, we have contracts of employment, collective bargaining, intellectual property and cyber contracts. The limit is boundless.

V. <u>SCOPE OF APPLICATION OF THE GENERAL PROVISIONS OF CONTRACT LAW ON SPECIAL CONTRACTS AND OTHER OBLIGATIONS.</u> The <u>theory of complementarity</u>. Arts. 1676 and 1677, Civ. C.

a. When it comes to contractual obligations, the general legal principles on the formation, effects and extinction apply not

only to general contracts that are fully regulated by Title XII of the Code, but also to all varieties of contracts that we find in Book V of the Code on Special Contracts and those in the Commercial Code and other laws. The most important point to take note of in this context is that this principle that is espoused by Art. 1676 of the Code applies to the extent that the matter to be regulated is not covered by specific legal provisions to be found in the province of the special law of which it forms a part. This is compatible with the general rule of interpretation of law known as special provisions of the law derogate from the general ones.

b. **The scope of Title XII goes further than regulating obligations that stem from contracts but also obligations that have extra contractual sources so long as the matters are not specially covered by a different law designed for its regulations. Art. 1677. See. For example, Civ. C. Arts. 756, 867, 991, 2143, 2146(2), and 2155.**

LECTURE NOTES ON THE LAW OF CONTRACTS
No. 2
ON THE CONTRACT FORMATION PROCESS

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I. GENERAL REQUIREMENTS.

a. **A contract is a juridical act and as such requires living up to certain standards of behavior in order for it to be able to bind its**

actors in the eyes of the law. These standards are outlined under Art. 1678 of the Code.

b. Capacity: The ability to perform acts sustainable under the law.

c. Consent: The free expression of one's willingness to enter into contractual obligations.

d. Object: The subject matter of the contract.

e. Form: Whenever required by the law or parties so agree, a contract may be made in a form prescribed by the law or agreed upon by the parties.

II. <u>CAPACITY TO CONCLUDE A CONTRACT</u>.

a. In general terms, the notion of capacity is not in the realm of the law of obligations of which the law of contracts is a part. It is rather an important legal principle of the law of status and refers to the ability of a person, whether natural or juridical, to perform an act that is sustainable (acceptable) in the eyes of the law. Although a person may have a particular right, he may not have the capacity to exercise it.

b. Such is the case of a child under eighteen who may own some property but who cannot contract on the same.

c. It is likewise the case with persons of unsound mind who are not in a position to fully appreciate the consequences of their actions.

d. In the olden days, convicted criminals, persons with disabilities, slaves, those who join the holy order (such as monks) and even women used to be considered as being incapable.

e. Modern law presumes capacity. It means that unless proved to the contrary, every human being is considered to have the required capacity to enter into juridical acts

including, of course, the power to conclude contracts.

f. Bodies corporate are also subject to the rule of capacity. Their capacity may relate to their objective or to their nature. Conditions may also be imposed upon incorporation with regard to the activities they may venture into. The law may restrict the activities to be undertaken by these organs.

i. Political parties may not engage in trade.

ii. Religious institutions should not enter into politics.

iii. Companies may only carry out activities for which they are licensed.

iv. There are also areas of capacity that are subject to rules on *special incapacity.* E.g. Foreigners may not engage in investment areas preserved for nationals. They may not own immovable property. Bankrupt persons may be restricted from involving in business activities for a certain period.

Government officials should not venture into business areas that are incompatible with their offices.

III. <u>CONSENT</u>.

a. The theory of consent is a fundamental principle that goes into the heart of any contract. Contracting parties are said to have willed the effects of a contract when it is seen that they have really expressed their desire to that effect. Read the provision of Art. 1679 of the Civ. C. in this context.

b. The consent of the parties to conclude a contract decomposes itself through a process known as <u>offer and acceptance.</u>

c. **Offer in the law of contracts is a promise or a commitment of one party to do or to refrain from doing some specified thing and creates a power of acceptance on the offeree (the person to whom the offer is made) that would transform the offer into a binding obligation.**

d. **Acceptance. "An acceptance is a voluntary act of the offeree whereby he exercises the power conferred upon him by the offer, and thereby creates the set of legal relations called a contract." Corbin. At the beginning, the offeror has full power to determine the acts that may constitute acceptance. Once he makes the offer, however, the power to transform it into a binding contract shifts to the person making the acceptance.**

e. **Forms of offer and acceptance.**

   i. **General rules. See Arts. 1681 and 1682. They can be made in writing, orally, by conduct or by signs normally in use. As a matter of principle, however, silence of a person to whom an offer is made does not constitute acceptance.**

   ii. **Exceptions to the rule of express acceptance. See Arts. 1682 to 1686 where there is/are:**

      1. **a duty to accept – a typical example in this regard is the responsibility of companies that provide public utilities and those that are engaged in financial services.**

      2. **a prior business relationship between the offeror and the offeree – a case in point is an offer made by a lessee to a lessor to elongate the contract of lease for**

a further period; such is also the case where an insured requests the insurer to extend the insurance cover for another term.

3. **an invoice based transaction in which particulars other than the sum regarded as payment that are not congruent with the terms and conditions of the main contract; and**
4. **general terms of business referring to standard contracts that are not expressly accepted by the offeree or that are not endorsed by the relevant public agency.**

f. Binding and Non-binding Declaration of intention.

i. **Mere declaration – advertisements, discounts, call for negotiations, circulation of catalogues and price tariffs that are not expressly directed to a designated person. See Art. 1687.**

ii. **Sale by auction – a special kind of offer whose acceptance depends on the results of a bid that designate the winner. Art. 1688.**

iii. **Public promise of reward. Art. 1689.**

g. Miscellaneous issues on offer and acceptance. Arts. 1690-95

i. **Offer with or without time limits.**

ii. **Counter-offer**

iii. **Withdrawal of offer and acceptance.**

h. Defects in consent. It is common knowledge that in order for a contract to produce the desired effect and bind the parties, it must be seen to it that it is free from any and all defects that vitiate the free expression of

will of its actors. This idea goes deep into the very foundation of the law of contracts – freedom of bargaining. It must be established that consent is given truly and consciously. A contract that suffers from such defects is susceptible to invalidation, i.e. being deprived of the protection of the law for its enforcement. As in almost all other contract law regimes, the Ethiopian Civil Code too lays down the grounds that constitute defects from the vantage point of consent. See Arts. 1696-1710 in general. These are mistake, fraud, duress and, under exceptional circumstances, unconscionablity.

i. **Mistake. (Arts. 1697-1703) Mistake in the law of contracts is referred to a wrong appreciation of a material fact in the terms and conditions of a contract by one of the parties. It must be substantial enough to be considered by a reasonable person that the mistaken party wouldn't have entered into the contract were it not for the mistake.**
    1. **Mistake as to the subject matter.**
    2. **Mistake of identity.**
    3. **Mistake on the cause that gave rise to the contract.**
    4. **Non-fundamental mistakes.**
ii. **Fraud. (Arts. 1704 and 1705) Fraud relates to deceitful acts of one party committed on the other on the basis of which that other party agreed to conclude a contract. For it to enable the victim to demand invalidation of the contract, the act of the recalcitrant should relate to a matter substantial to the bargain so much so that he wouldn't have entered into that**

contractual arrangement were he not deceived. The fraud may relate to:

1. **Material misrepresentation of the subject matter of the contract or the identity of the contracting party. A false statement. Commission and;**
2. **Concealment of a material fact that ought to have been disclosed to the other party. An omission.**
3. **Fraud may also have tortuous and/or criminal consequences.**

iii. **<u>Duress</u> (Arts. 1706-09). In the ordinary course of events, any wrongful act or threat that overcomes the free will of the parties in consenting to contract formation can be considered as duress. It is also required to be of such a nature and severity that a reasonable person would not have concluded the contract if it were not for the act of duress. The following are additional points to be taken into account in this regard.**

1. **The danger to which the victim is exposed must be clear and imminent.**
2. **The person subject to the duress may be the contracting party himself or those to whom he owes support and protection.**
3. **The coercion may be on the person, property or prestige of the victim or those to whom he owes allegiance.**
4. **The form of duress may be direct, indirect, physical or psychological**
5. **The person exercising the duress may be one of the parties to the**

contract or some other person who coerces the victim to enter into the contract with or without the blessing of that party.

6. **A threat to exercise one's right does not amount to duress unless it is so excessive that the party availing himself of such threat has made an undue advantage against the other party.**
7. **Reverential fear does not count unless excessive.**

iv. <u>Unconscionablity.</u> The expression "unconscionable" is not actually a legal term but a notion of morality that is employed to denote an act that affronts human sense of decency. In contract law, it is generally held that an unconscionable contract is a contract in which one party takes an excessive advantage over the other by exploiting his dire need, ignorance of the bargaining process, business inexperience or similar other weaknesses. This is regarded as a contractual obligation which no reasonable debtor would assume and no humble and honest creditor would claim.(Art. 1710)

1. **As a matter of general principle of law, the prevalence of gross unproportionality per se in a contract does not bring about its invalidity.**
2. **The elements of want, simplicity of mind and manifest business inexperience that are stated under Sub-Art. 2 of Art. 1710 are required to be met.**

IV. <u>SUBJECT MATTER OF A CONTRACT</u>

a. **<u>The Basic Issue</u>. The doctrine of freedom of K has it that parties have full measure of autonomy to determine the subject matter of their K. This is, of course, without prejudice to limited exceptions imposed by the law in consideration of the general public interest. See Civ. C. Art. 1711. Questions such as: With whom to conclude a K? How to conclude? What its terms and conditions may be? In what ways should the obligations be performed? What additional means of guaranteeing performance should be ensured? What civil sanctions should be imposed on a recalcitrant? What form should communications of the parties assume? In what ways may disputes stemming from the K be resolved? And similar others are, by and large, left for the parties to regulate. The purpose of the law is to lay down general guidelines that are meant to help parties when they contemplate of concluding Ks. The provisions of the law are mostly permissive in nature in the sense that they can be derogated from by the parties.**

b. **<u>Determination of Object.</u> As pointed out earlier, the subject matter of a contract is the creation, variation and extinction of obligations of a proprietary nature. Parties to a contract normally agree to do something, to refrain from doing something or to handover something. Take the case of a contract of sale: Buyer's obligation is to pay the price and take delivery of the thing. Seller's obligation, on the other hand, is to deliver the thing. The reason for the buyer's payment of the price is the agreement of the seller to sell the thing and vice versa. The nature of the transaction here is to give the money (buyer) and to give the thing (seller). Take again the case of a service contract:**

Client's obligation is to pay the agreed service charge (obligation to give). Service provider's obligation is to perform his duty as agreed (obligation to do). In an obligation not to do, a person may relinquish making make use of his right in consideration of a price or some other benefit. Such is the case of one who agrees not to make use of his title over a piece of property against payment of royalties or other remunerations. It is thus this obligation to do (commission) or not to do (omission) that, in the parlance of the law, is known as the object of a contract. See Art. 1712

c. Features of Object.

i. It must be defined – Must be good enough to enable others understand the respective rights and obligations of the parties. What is the contract all about? We need to get the answer to this question from the contract itself. It is not up to the court or any other third party to tell what the parties intended to agree on. (Art. 1714)

ii. It must be possible – Must be capable of being performed by the parties with little or no difficulty. Impossibility may be that of fact or that of law. It may be pre or post contract. (Art. 1715)

iii. It must be lawful – No contract can stand where its object is infringement of the law. One cannot agree to commit or not to commit a crime. In both cases he does not have a right to give his consent. (Art. 1716)

iv. It must stand the morality test – The law also speaks of immoral contracts but remains short of telling us what it means by morality. Not all people

would entertain similar views on what constitutes immorality with respect to a certain conduct. At times, it is exposed to subjectivity of judgment. Factors such as culture and religion also influence our perception of morality. Despite that, however, there may be areas of morality that a given society may take for its own. (Arts. 1716 and 1718)

V. FORM OF CONTRACTS

a. The Rule - Contract laws do not require observance of specific formalities in all cases. In fact, the majority of our daily economic dealings that are contractual in nature are done in a consensual manner, there being no need to adhere to any specific formal requirements. Consider the provision of Art. 1719 of the Code that reads as follows: *"Unless otherwise provided, no special form shall be required and a contract shall be valid where the parties agree."* The question then is: Who may provide "otherwise"? A short answer to it is: The parties themselves or the law.

b. Form stipulated by the parties (Arts. 1719/1 and 1728). In as much as parties are at liberty to determine the object of their contract, so are they at liberty to agree on a particular form their agreement should assume.

c. Form Required under the Law (Arts. 1723 – 1725)

i. Taking into consideration the volume of transaction in a contract, the nature of the bargain, the duration in which the contract is supposed to last, the number of parties, issues of public interest that is likely to be involved in the contract and similar other matters,

the law may specify a fulfillment of a particular formality for conclusion of a contract. To mention but a few, the following are such instances:

1. **Contracts relating to immovable property;**
2. **Contracts of guarantee;**
3. **Contracts of insurance;**
4. **Contracts on the formation of business organizations;**
5. **Contracts evidencing collective agreements; and**
6. **Contracts with public administrative agencies.**

ii. **Once a contract is made in a specified form, it may further be required to have the signatures of parties and witnesses unto it; to be attested by witnesses; to seek authentication by public authorities or by private entities so delegated to undertake such businesses; to have it publicized; or to meet governmental duties on licensing and payment of revenue stamps.**

No. 3
ON EFFECTS OF CONTRACTS

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I. PRELIMINARY POINTS.

a. **Provisions governing the contract formation process regulate the mode of creating a valid contract - the birth of a contract. Those on effects lay down the multitude of consequences that follow the creation of a contract. To this end, they not only recognize a contract as a juridical act, an act sustainable under the law, but also elevate the status of a contract to that of the law.**

b. **This is what, in the wording of jurists, is referred to as the doctrine of sanctity of contracts – the *pacta sunt servanda*. In this context, a brief analysis of Art. 1731(1) is in order. It provides thus: "The provisions of a contract lawfully formed shall be binding on the parties as though they were law." The elements of this provision are thus:**
   i. **"A contract lawfully formed" – an obvious reference to Chapter 1 of Title XII on formation of contracts.**
   ii. **"Binding on the parties" – an exposition of the doctrine of privity of contracts, or in other words – the doctrine of relativity of contracts.**
   iii. **"As though they were law" – the theory of sanctity of contracts.**

c. **The contents of a contract are to be freely determined by the parties (freedom of contract) subject to mandatory provisions of the law (limitations to contractual freedom) – Art. 1731(2).**

d. According to Art. 1731(3) the provisions of the law on contracts do apply to contracts only where:

i. There is a mandatory rule from which parties cannot derogate, or

ii. Parties themselves opt for their inclusion in their contract.

e. <u>Structure of the Chapter on Effects of Contracts</u>. Writing on the structure of the chapter on effects of contracts, Prof. Krzekzunowics succinctly states thus: "*The due effects of a contract are ascertained by interpretation, fulfilled by performance, changed (exceptionally) by judicial variation, and sanctioned by the rules on non-performance*." It is against this background that a law student needs to study the sections outlined below.

i. Section I - (Arts. 1731- 39), On interpretation of contracts.

ii. Section 2 - (Arts. 1740 - 62), On performance of contracts.

iii. Section 3 - (Arts. 1763 - 70), On variation of contracts by courts.

iv. Section 4 - (Arts. 1771 – 1805), On non-performance of contracts. This last Section includes the various aspects o f non-performance including:

1. The general rule under Art. 1771;

2. Rules on notification (Arts. 1772 – 75);

3. The various forms and theories of forced performance such as those on specific performance (Art. 1776), on creditors' self-help (Art. 1777), on purchase in replacement (Art. 1778), on delivery (Arts. 1779 – 80), compensatory sale (Art. 1781), on deposit of debt (Arts. 1782 – 83), on cancellation of contracts on damages and the appertaining questions of

force majeure and assessment of damages (Arts. 1790 -1805)

II. INTERPRETATION OF CONTRACTS.

a. **Basic questions:** **What is meant by interpretation? Why do we need interpretation? When should contracts be interpreted? How do we interpret contracts? Who interprets contracts? In a broader understanding "*interpretation is a process whereby one gives a meaning to the symbols of expression used by another person.*" Corbin.**

b. **As much as possible, contracts are required to be clear enough not to call for interpretation. This is a fundamental problem to be addressed in contract drafting since ambiguities are undesirable in legal instruments including, of course, contracts. Nevertheless, in the real world it is not always possible to do away with interpretation as there is *no lawyers' paradise*, so goes the saying, where all words and phrases in legal instruments have fixed and ascertainable meanings.**

c. **Interpretation is thus the art or process of discovering and ascertaining the meaning of a statute, will, contract or other written document whose terms are not clear or are susceptible to multiple meanings. Under such cases, parties may:**
   i. **Agree to come up with an acceptable interpretation;**
   ii. **Agree to have their contract interpreted by a third party, expert opinion included;**
   iii. **Seek judicial interpretation.**

d. **The rule is thus against interpretation. As the saying goes: "A plain contract means what it says." This is known as the plain meaning rule. This rule is reflected under Art. 1733 cum**

1714(2) of the Code. Interpretation only becomes necessary when a contract or a provision thereof is not clear enough to convey the intention of the parties through. (See Art. 1734)

e. <u>General Rules of Interpretation</u>.

i. When there is need for interpretation, <u>the common intention of the parties</u> at the time of concluding the contract needs to be looked into, though this is an arduous task to be embarked upon. (Art. 1734) Whoever is in charge of interpretation should be diligent enough not to undo what the parties have done when they made the contract. Nor should he arrive at unintended result under the guise of interpretation. To sum up, the interpretation should come from the contract, not the contract from the interpretation. All circumstances giving rise to the transaction should be considered in finding out the true meaning of words and phrases.

ii. Interpretation should give due regard to good faith that is expected to exist in every contract and to usage regarding the controversial issue. (Art. 1732) A case in point is that of INCOTERMS in international trade.

iii. Construction of <u>general terms</u>. (Art. 1735) Should be narrow not to go out of the original intention of the parties. Dictionary meanings do not always lead us to the desired result in interpretation. Where there is an inconsistency between general and specific provisions, preference is given to the latter.

iv. <u>Positive interpretation</u> (Art. 1737). Acts should be interpreted in favor of effectiveness. An interpretation that gives

a reasonable and effective meaning is preferred than the one which does not.

v. **Contextual interpretation. (Art. 1736) A contract should be interpreted as a whole and all writings forming part of the same transaction are interpreted together.**

vi. **Interpretation in favor of the debtor. (Art. 1738/1) In ambiguous obligations, the favored party is normally the debtor since the burden of proving the existence of an enforceable right rests on the shoulder of the creditor.**

vii. **Interpretation of a provision in a contract of adhesion is in favor one that did not author the contract. (Art. 1738[1]) The application of this rule holds good only in the event of doubt. As the old adage goes: "*Verba contra stipulatorem interpretanda sunt*", words are to be interpreted against the stipulator.**

viii. **Interpretation of gratuitous contracts. (Art. 1739) Should be in favor of the party assuming the obligation.**

III. PERFORMANCE OF CONTRACTS

a. **Some basics:- Performance is the normal and the most desirable mode of extinction of contractual obligations. In other words, it is the manner of fulfilling the due effects of a contract, whether plain or ascertained by rules of interpretation. It answers basic questions such as: Who may perform? Who shall receive performance? What shall be performed? Where and when is a contract to be performed? It also addresses issues relating to appropriation of payment (performance), cost of performance and transfer of risk.**

b. **Who may perform?**

i. **General rule: The debtor, his designate, his guarantor, those bound by a joint and**

several obligation with the debtor or any other third party. (Art. 1740/2). Even a person who doesn't have any meaningful relationship with the debtor may perform the contract on the debtor's behalf. Creditor need not insist on the personal performance by the debtor of his obligations.

ii. **<u>Special cases</u>: Only the debtor when this is of special interest to the creditor. Examples are most service contracts, agent-principal relationships or contracts where the special quality of the debtor is the basis of the agreement. One may take an advertisement show contract with a celebrity as an example here.**

c. <u>Who may receive performance?</u>

i. **Normally the creditor alone receives payment since payment to an unqualified person may not absolve the debtor of his liability to the original creditor. See Art. 1741 *cum 1743/1.***

ii. **Third parties may only receive upon delegation by the creditor, or by a court order or by operation of the law. Such is the case of duly appointed agents of the creditor; creditors of the creditor himself; guardians and tutors of the creditor; heirs and legatees of the creditor; liquidators in bankruptcy or in succession of the estate of the creditor; trustees of the creditor; assignees of the creditor; or those bound by joint and several right with the creditor.**

iii. **Where payment is made to a creditor incapable of receiving under the law, there is a likelihood of the debtor being liable to double payment unless he proves that the payment has benefited the recipient. The same is true in relation to payment made to an unqualified person if it is not ratified by the creditor. See Arts. 1742 and 1743.**

iv. **Where there is doubt as to the exact identity of the creditor (Art. 1744) in cases involving conflict of interest between several creditors of the same debtor; or dispute between those claiming rights of a creditor who has passed away; or in circumstances of the bankruptcy of the creditor, debtor may deposit the amount with a court or with another entity so instructed by a court. He may likewise bring an action of interpleading following the rules specified under Arts. 293 to 299 of the Civil Procedure Code. Failure to do so may again expose the debtor to double payment.**

d. **<u>How may a contract be performed?</u>**
   i. **<u>The Principle</u>:- As a rule, a contract is to be performed in strict compliance with the agreed upon terms and conditions. A creditor may refuse to accept a thing other than that due to him. He may even refuse a thing of a better quality or of greater value compared to what he has agreed to receive. (Art. 1745). This has much to do with the <u>notion of conformity</u> that abounds modern contract laws. Identity of performance is important. See Art. 2288 of the Code which provides thus: *"The thing shall not be deemed to conform to the contract, (a) where the seller delivered part only of the thing sold; or a greater or lesser quantity than he had undertaken in the contract to deliver; or (b) the seller delivered to the buyer a thing different to that provided in the contract or a thing of a different species."***
   ii. **<u>Partial performance</u>:- (Art. 1746)**
      1. **Creditor is at liberty to accept or to refuse partial performance unless partial performance is in the essence of the contract such as payment by**

installment or agreement for partial delivery.

2. **Where part of the debt is contested, creditor may require the debtor to perform the admitted portion of the obligation.**
3. **Where there are several creditors of the same debtor availing themselves of the rule of benefit of division, some of them may accept partial performance.**
4. **A court executing a judgment may instruct a creditor to receive partial performance.**

iii. **<u>Fungibles</u>:- (Arts. 1747 and 1748)**

1. **The expression fungibles refers to commodities or goods that are commingleable or interchangeable in their nature. They are goods that are identical with others of the same size. Agricultural commodities such as grains and oil seeds, metals of the same species, quarry products of similar quality and ordinary (common) shares of the same company are examples of fungibles.**
2. **Choice is the discretion of the debtor as long as he maintains the average quality and, where circumstances warrant, sufficient quantity.**
3. **Provisions for measurement differences and minor discrepancies on quality may be made to offset whatever inconvenience the creditor may suffer. These are differences that appear in weighing, packaging, breakage or due to evaporation of some substances.**

iv. **<u>Money debts</u>:- (Arts. 1749 -1754)**

1. **<u>Currency:</u>- The rule is payment by means of local currency. Even if payment is agreed to be made by**

some foreign currency, the law requires it to be converted to a local one at the rate valid when the debt becomes due. This has to do with a country's fiscal and monetary policy and pertinent laws on same. If parties do not want to assume risks arising from inflation, they may agree to fix the obligation of the debtor by referring to the value of some commodities, or objects or services to be realized at the time of payment. Precious metals such as gold and diamonds are typical examples of this kind of arrangement.

2. **<u>Interest:</u>- Depending on the agreement of parties, money debts may be interest-bearing or non-interest-bearing. Note, however, the following.**
    a. **Where the debt is interest-bearing, the rate is to be determined by the parties. The maximum rate per annum is 12%. (See Art. 2479/1). This does not apply to banking transactions as the National Bank of Ethiopia may determine a rate higher than 12%. (See Proc. No. 29/1993)**
    b. **Where a rate higher than the 12% ceiling is fixed, the rate will be reduced to the legal rate, i.e. 9%. (See Art. 1751 *cum* 2479/3)**
    c. **Where the debt is interest-bearing and no rate is fixed by the parties, the legal rate, i.e. 9%, applies. (Art. 1752 *cum* 2479/2)**
    d. **Parties may agree to raise the rate of within the legal ceiling should the debtor default.**

e. **Where the debt is non-interest-bearing, the creditor may not require interest before the debt becomes due. But he may require interest after the date of maturity by serving notice of default on the debtor. (Art. 1772)**

3. **<u>Imputation of payment</u>:- (Arts. 1752 and 1753)**
   a. **Imputation ('appropriation' as the Civil Code describes it) becomes an issue when the debtor who is liable to pay interest and cost, in addition to the principal debt, cannot settle accounts with his creditor at one go. It may also be seen in terms of the number of different debts that a single debtor owes his creditor.**
   b. **Where there is a single debt, any part payment is made to go to the cost, the interest and the principal debt, in that order. If the payment covers only the cost or if it does not even cover the cost, nothing goes to reduce the interest or the principal debt. If the part payment only covers the cost and the interest, the principal remains outstanding. If the payment covers the cost and the interest and there is still some more in excess, that excess is employed to reduce a portion of the principal debt.**
   c. **Where there are several debts, the choice is left for the debtor to decide as to which one of the debts the payment is to be utilized. If he fails to do so, the choice normally reverts to the creditor.**

e. <u>Where and when may a contract be performed?</u>

i. <u>Place</u>:- (Art. 1755)

1. **Place of performance is relevant in terms of ascertaining the local and/or judicial jurisdiction of the court competent to hear the case in the event of dispute; determining the kind of currency to be used for payment; and deciding the party that is supposed to bear the cost of payment.**
2. **Normally performance is to be carried out at the agreed place. Where there is no agreed place in the contract, the law supplements the deficiency. Subscribing to the old adage *'<u>payment is fetchable and not portable</u>'* the law thus says, the normal residence of the debtor is the place of payment. Hence the duty to seek performance is that of the creditor and NOT of the debtor.**
3. **Place of performance may also be determined taking the circumstances of the contract, the nature of the obligation and business custom into account, in which case the place may be a place other than the normal residence of the debtor. Service contracts and contracts relating to construction works are good examples in this regard.**

ii. <u>Time</u>:- (Art. 1756)

1. **The time of performance is normally determined by the contract. He who has the benefit of time may not be required to perform the contract before the date of maturity. Most minor contracts do not, however, carry terms as both parties perform their obligations simultaneously.**

2. **Where no time is fixed under the contract, performance may be made whenever the creditor requires it. He does so by showing that he has performed his part of the obligation or, if that is not yet due, by at least demonstrating his willingness to live by his promise. This has its origins in the Roman maxim of *'exceptio non adimpleti contractus'* in which it was held that the plaintiff is not entitled to sue if he has not performed his own part of the agreement. This rule is reflected in Art. 1757.**
3. **In the case of *anticipatory breach of contract* by the other party, the one bound to perform may refuse to do by showing that the other party has:**
    a. **expressly vowed not to discharge his part of the obligation;**
    b. **refused to tender the required securities that would ensure performance of his part of the obligation; or**
    c. **been declared bankrupt.**

f. Who covers the cost of performance?

i. **The expression 'cost of performance' implies additional expenses that may be incurred in the course realizing the contract. This may relate to transport costs, to costs of sampling, weighing, packaging, quality testing, counting, storage and preservation. Cost may likewise denote payments made by way of customs duties, bank money transfer charges, insurance premiums and expenses for transfer of title.**

ii. **Normally, the debtor is supposed to cover such costs. (See Art. 1760) Nevertheless, parties may, agree in the contract on the manner of apportioning these costs. (See**

Arts. 2314 -2319 for application of this rule in the Ethiopian Law of Sales.)

g. <u>Theory of Risk</u>:- (Art. 1758 *cum* Arts. 2323 – 2328)

i. **Risk allocation is an important issue in the law of contracts, especially in those relating to sales contracts. This is due to the fact that the things that have been subjected to sale or to transfer may be lost, damaged, destroyed or stolen after the conclusion of the contract but before they are physically transferred from one party to the other. The modality of such risk transfer may be regulated by the parties themselves or by operation of the law if such arrangement is not earlier agreed upon.**

ii. **The question, as stated by Prof. Krzeczunowics is thus: *"Who of the two, creditor or debtor, stands to lose by an unpreventable loss or deterioration of the thing? If the debtor, he shall not be paid. If the creditor, he shall pay the debtor despite the loss."***

iii. **The rule on transfer of risk is an extension of the Roman legal maxim '<u>*res peris domino'*</u>. According to this maxim, when a thing is destroyed, damaged or lost it was lost to the person who was its owner at the time.**

iv. **The general rule is that delivery transfers the risk. But even before delivery, when the party obliged to take delivery fails to do so at the agreed time risk passes to him despite the physical presence of the goods with the original owner.**

v. **Strict application: Rule applies only to corporeal chattels and to contracts based on consideration.**

vi. **Consider the following provision from the United Nations Convention for the**

International Sale of Goods, *alias,* <u>the CISG</u>: *Article 69:-"(a)…the risk passes to the buyer when he takes over the goods or, if he does not do so in due time, from the time when the goods are placed at his disposal and he commits a breach of contract by failing to take delivery. (2) However, if the buyer is bound to take over the goods at a place other than a place of business of the seller, the risk passes when delivery is due and the buyer is aware of the fact that the goods are placed at his disposal at that place. (3) If the contract relates to goods not then identified, the goods are considered not to be placed at the disposal of the buyer until they are clearly identified to the contract."*

IV. <u>JUDICIAL VARIATION OF CONTRACTS</u> (Arts. 1763 – 1770)

a. **<u>The Rule</u>:- The right to make variation to a lawfully formed contract is that of the parties and the parties alone. Not even in the case of gross disequilibrium of the obligations assumed by the parties may a court vary or alter the terms of a contract with a view to ensuring equity. Parties are normally expected to foresee the occurrence of conditions that may bring about changes in the magnitude of their obligations. Examples of such foreseeable occurrences may be fluctuations in currency exchange rates, in prices of raw materials, in labour costs, in transport expenses, and issuance of new laws, tax or otherwise, that make the obligations of one of them more onerous than was foreseen. (See Arts. 1763 – 65) Under such circumstances the parties may:**

- ***i.*** **Regulate the consequences of such imbalances by inserting a *<u>variation clause</u>* that would entitle them to seek modification of the contract should**

circumstances occur that render the obligation of one of them more burdensome than was originally assumed; or

ii. **Agree to make amendment to the contract after the happenstance of an event that unreasonably aggravates the obligation of one of them; or**

iii. **Submit the new fact to arbitration to have the issue resolved in an amicable manner.**

b. **The exceptions:- (Arts. 1766 -1770) The following grounds may, however, entitle the aggrieved party to seek judicial variation of contract terms. Nevertheless, the party claiming variation should show that the circumstances that appear after the making of the contract have unreasonably increased their obligations.**

i. **Special relationship between the parties. Examples may be that of parties bound by family ties, professional bonds, relations stemming from confidence they place on each other and principal-agent arrangements. (Arts. 1766, 2219, 2635, 2646/3)**

ii. **In contracts with a public administration, the private entity may seek judicial variation if a separate move by the Government changes the balance of the contract to the detriment of the private party. Increase in tax, in concession fee, in land lease price, or in price of petroleum products may be taken as grounds that warrant petition for variation. (See Art. 1767)**

iii. **Partial impossibility of performance. Where a substantial portion of a debtor's obligation is performed, the court may reduce the obligations of both parties to restore the balance of the contract instead of causing the cancellation of the contract.**

(Art. 1768 and 1769) This is sometimes referred to as the <u>doctrine of substantial performance.</u> This doctrine has its roots in commercial reasonableness according to which the rendering of performance that does not exactly conform to the letters of the agreement is considered as fulfillment of the debtor's obligations subject to compensating the creditor for whatever economic harm he may sustain on account of the slight deviation by the other party.

iv. **Petition for period of grace by the debtor. Court may grant the debtor additional time to discharge his obligations where this is necessary in the interest of equity. As the name itself denotes, court may grant or refuse the plea. When it does so, the maximum period under the law is six months. Parties may also agree not to seek period of grace ahead of time in which case the court is deprived of its discretion to grant leave for additional time. (Arts. 1770, 2338 and 2339)**

V. <u>NON-PERFORMANCE OF CONTRACTS</u>

a. <u>The Basics.</u>

i. **The provisions relating to non-performance of contracts are primarily designed to lend the hand of the law to the aggrieved party in a contract and ensure the sanctity of promise. They are essentially sanctions meant to be imposed on a party who fails to carry out his duties in a contract. The Civil Code, however, only provides the consequences of non-performance without stating the grounds that constitute it. (See Art. 1771) In the ordinary parlance, the expression non-performance of a contract refers to a contracting party's refusal to do an act**

that he has promised to do (nonfeasance); or to refrain from doing an act that he has committed himself not to do (misfeasance). See Art. 1712/1. In other words, it is a contracting party's failure to live up to his expectations. It is also known as <u>breach of a contact</u> in most literatures. The debtor might have performed his obligations; but has done it in a manner different from what was initially expected of him causing damage to the interest of the creditor, for which he will be liable to redress the latter.

ii. **The remedies for breach of contract the law accords to the creditor are, therefore:**

1. **Forced performance;**

2. **Cancellation; and**

3. **Right to claim damages.**

iii. **Please also take note of the fact that remedy No. 1 may be sought with remedy No. 3; and also remedy No.2 with remedy No. 3; but NOT remedy No. 1 with remedy No. 2**

iv. **Following the adage *'claims are fetcheable, not portable'* the law requires the creditor to place the debtor in default in order for him to avail himself of the benefits due to him where the other party fails to honor his obligations. The structure of the Section on Non-performance is thus crafted in the following pattern. Rules on notice (Arts. 1772 – 75); Rules on forced performance of contracts (Arts. 1771/1, 1776 – 83); Rules on cancellation of contracts (Arts. 1771/1, 1784 – 89); and Rules on damages (Arts. 1771/2, 1790 - 1805).**

b. **<u>Notice</u> (Arts. 17772 – 75)**

i. **Unless agreed by the parties otherwise or expressly provided by the law, a creditor**

seeking contract remedies for breach is always required to place the other party in default by serving notice on him. The purposes of notice are manifold. Some of which are: (1) entitlement of the creditor to seek additional compensation; (2) transfer of risk to the debtor; (3) reminding the debtor to discharge his obligations; and (4) reduction of court case-loads.

ii. **No special form or fixed period is required so long as the means of communication and the time given is good enough to let the debtor perform the obligation.**

iii. **The circumstances under which notice may not be a requirement are enumerated under Art. 1775 of the Code. These are (1) when the debtor in breach of a contract term has performed an act which he has agreed not to perform; (2) where the obligation of the debtor is a time-bound one in the sense that performance becomes meaningless after the passage of the agreed time; (3) where the debtor has unequivocally declared his intention not to perform the contract by a written instrument; and (4) where parties have waived their right to seek notice in the contract.**

c. **<u>Forced Performance</u>: - (Arts. 1771/1, 1776 – 83)**

i. The debtor may be required to perform the contract as agreed; to pay a sum certain in money; to handover a specified thing to the other party; or to remove or demolish works that he has done or he has caused to be done in violation of his earlier promise in a contract. Forced performance is normally realized through a court order and the property of the debtor. As the saying goes, 'the property of a debtor is

the security of his creditors'. (See Art. 1988 of the Code and Arts. 394, 399, 400 and 402 of the Civil Procedure Code)

ii. **<u>The case of specific performance</u>. It is generally held that contract law has two methods of achieving its goal of redressing an aggrieved party. This may be by way of requiring the debtor to pay damages that would enable the creditor to purchase a substituted performance or to replace the net gains that performance would have brought about to him. The other way may be to require the debtor to discharge his obligation as agreed. This second remedy entitles the creditor to require exact performance of a contract in the specific form in which it was agreed to be made or according to the precise terms it was agreed upon. The following are some of its special attributes, though.**

1. **Specific performance is an exceptional contract remedy to the general remedy of awarding damage to the aggrieved party. (See Art. 1776)**
2. **It is to be realized taking into account the special interest of the creditor and where there are no other means of redressing him. (See for example Art. 2329 on the sale of special objects; Art. 2892 on delivery of immovable property by the seller to the buyer; and Art. 2621 on the duty of a client to take delivery in a construction agreement.)**
3. **The capacity of the debtor to carry out the obligation as agreed is a prerequisite.**
4. **Debtor's personal liberty should not in any way be endangered when forcing specific performance upon him. Most service contracts are not amenable to specific performance as this may**

entail a high risk of jeopardizing the personal liberty of the debtor.

iii. **<u>Creditor's self help in performance</u>:- (Arts. 1777 – 79)**

1. **Where the obligation of the debtor is to do something and specific performance is not the appropriate option, the creditor may resort to doing what the debtor has agreed to do and claim damages if he sustains economic harm in so doing. In a contract of sale, for example, if the buyer refuses to take delivery of the thing he bought, the seller may sell it in an open market. This is known as <u>compensatory sale</u> (See Art. 2333 *cum 1778*) Likewise, if it is the seller that has refused to deliver the goods as agreed, the buy may resort to sellers having similar goods and benefit from the rules that pertain to <u>purchase in replacement</u>. (See Art. 2330 *cum* 1778)**
2. **Where the obligation lies in refraining from doing something, the creditor may demolish the act or cause it demolished at the expense of the debtor. (See Art. 1777/2)**

iv. **Where the a creditor refuses to accept the thing or where he is not known with absolute certainty, the debtor has the following options:**

1. **Deposit the money in a bank or in a warehouse at creditor's expense. (Arts. 1779 and 1780)**
2. **Sale the thing where the goods to be delivered are of a perishable nature or where they entail high cost of preservation. (Arts. 1781 – 1783)**

d. <u>Cancellation of a Contract.</u>

i. **Cancellation of a contract is an act whereby a party brings a contract to an end as a result of the other party's failure to perform his obligations. As such, cancellation presupposes validity. It was perfect upon formation but fails to produce the desired effect when one of the parties does not perform his obligation in whole or in part. On the other hand, a contract that suffers from defect at the time of formation may be void or voidable and hence susceptible to invalidation. Cancellation is normally judicial and, under exceptional situations, unilateral.**

ii. **In a <u>judicial variation</u> (Arts. 1784 and 1785), the aggrieved party takes his case before a judge and prays for cancellation by showing that the other party has failed to substantially carry out his duties. This right is realized by showing that the other party has breached a fundamental provision of the contract. What is fundamental, as opposed to trivial, is a matter to be determined by the court taking the relationship of the parties and the circumstance giving rise to the contract into account. As it is a formula susceptible to high degree of subjectivity, care needs to be taken in the determination of the type of breach. Examples may be alienation of the thing sold in a contract of sale, failure to tender the required performance bond in a construction contract, absence of professional license in a contract for professional service or the bankruptcy of one of the contracting parties.**

iii. **<u>Unilateral cancellation</u> takes when one of the following conditions is present. (Arts. 1786 – 89)**

   1. **Where the parties have inserted a *cancellation clause* in their contract**

and the conditions for cancellation specified therein materialize;

2. **Where performance by the other party becomes fully or partially impossible;**
3. **Where a timeline for performance fixed in the contract has lapsed and performance afterwards becomes meaningless; and**
4. **Where the other party has declared his intention not to perform the contract in a written instrument.**

e. <u>Award of damages</u>:- (Arts. 1790 -1805)

i. <u>Principle of damage</u>:-

1. **Damage is the most import <u>*right in personam*</u> in both contractual and non-contractual obligations. According to Black's Law Dictionary, damage is *"a pecuniary compensation or indemnity, which may be recovered in the courts by any person who has suffered loss, detriment or injury, whether to his person, property, or rights through the unlawful act or omission or negligence of another… Damages may be compensatory or punitive according to whether they are awarded as the measure of actual loss suffered or as punishment for outrageous conduct and to deter future transgressions. Nominal damages are awarded for the vindication of a right where no real loss or injury can be proved."***

ii. Damages may be immediate resulting in the pecuniary losses by the plaintiff by way of out-of-pocket-type expenses *(Damnum emergence;)* or future by way of a lost income or some expected gain *(lucrem cessans).* In view of this, damages

may be broadly categorized into the following:

1. **<u>Actual or compensatory</u>:- Damages that are meant to redress the actual harm sustained by the victim. They are awarded to the plaintiff with a view to solely compensate him for the injury he sustained. No more, no less.**
2. **<u>Consequential</u>:- Losses that do not directly and immediately flow from the actions or omissions of the defendant but from some of the results of the act after a while.**
3. **<u>Liquidated</u>:- The sum which a contracting party agrees to pay if he fails to perform the contract as agreed. Parties may agree to fix the amount to be paid in lieu of performance as a pragmatic pre-estimate of the harm that is likely to be sustained by the party not at breach.**

iii. As a contract remedy, the purpose of damage is to place the aggrieved party in as a good a position as he would have been had the contract been smoothly performed. This serves both the <u>reliance and the expectation interests</u> of a creditor. Although damage is usually material, it may also be moral. The former is relatively easier to quantify and is, if properly computed, has a propensity of being much closer to the economic harm sustained by the creditor than the latter. As pointed out above, damage may be sought either with a petition for forced performance or for cancellation. Refer to the expression "apart from and in addition to the enforcement or cancellation of the contract" under Art. 1790/1 *cum* 1771/2 of the Code.

iv. **<u>Duties of the creditor</u>:- To be able to succeed in an action for damages, the plaintiff (creditor) has to show (1) existence of the contract; (2) defendant's (debtor's) failure to perform his obligation under the contract; and (3) the economic loss (immediate or future) he has suffered or is likely to suffer as a result of this breach. (1791/1)**

v. **<u>Defenses of the debtor</u>:- The debtor may avail himself of ordinary and special defenses to disclaim liability. Ordinary defenses relate to the defendant's contention on the existence or validity of the contract; to performance or denial of harm alleged by the plaintiff; or to those espousing the responsibility of the plaintiff for the alleged harm. These are matters to be supported by evidence and do not have much to do with legal issues.**

vi. **<u>Special defenses</u> pertain to prevention of performance by *<u>force majeure</u>* as stated under Arts. 1792 and 1793 of the Code. As defined under Art. 1792/1 of the Code, "*force majeure results from an occurrence which the debtor could normally not foresee and which prevents him absolutely from performing his obligations".* The cumulative tests of force majeure are thus:**

1. **<u>Externality</u>:- the cause that gave rise to force majeure should not have been attributable to the act of the debtor. In other words, the source must be external to the debtor.**
2. **<u>Insurmountability</u> :- the cause should be beyond the control of the debtor. Irresistible cause, as it is sometimes referred to.**
3. **<u>Unforeseeablity</u> :- the cause must not be reasonably expected to take place.**

4. **<u>Impossibility</u>:- performance has been made absolutely impossible by force majeure.**

vii. **The Code has open-ended enumeration of acts that may be considered to constitute force majeure under Art. 1793: (1) An unforeseeable act of a third party; (2) Official prohibition; (3) Natural catastrophe; (4) War; and (5) Death, serious accident or unexpected illness of the debtor. All these are, however, subject to the tests specified above. Take note also of the fact that this enumeration is exhaustive since a court or an arbitration tribunal may include other grounds as force majeure when circumstances justify.**

viii. **It also provides restrictive enumeration of grounds that do not constitute force majeure unless the parties agree to include them in a contract by a force majeure clause. These are strikes, lock-outs, fluctuations in prices of raw materials and enactment of new laws that render the obligation of the debtor more onerous than he anticipated. (See Arts. 1794)**

ix. **The special place of obligations of diligence as opposed to obligations of result. In an obligation of diligence, the duty of the debtor is to do his level best to cause the occurrence of the result sought. Unless the other party shows that the defendant has committed grave fault, the debtor cannot be held liable for not being able to produce the intended result. Such is the case in contracts made with physicians or with lawyers. (See Arts. 1795, 2636 and 2647)**

x. **The same holds true for contracts of gratuity in which the obligation is assumed only by one of the parties to a contract. Contracts of donation or bailment in**

distrust (Arts. 1796, 2427 *et seq,* 2784, 2800 – 03)

xi. Debtor may not avail himself of the defense of force majeure if the occurrence takes place after he is placed in default by the creditor. (Art. 1797 and 1798)

f. <u>Form and extent of damages</u>:-

i. Damages may be determined by prior agreement of the parties or by operation of the law. The general rule is, however, the maxim *'compensation is equal to damages'.* (See Arts. 1790, 1799, 2090 and 2091). There are also minor instances where greater or lesser damages may be awarded to the creditor. (See Arts. 1800 and 1801).

ii. Damage is also required to have a cause and effect relationship with the non-performance of the debtor. Not only should it be related to the breach, but is also required to be proximate enough to convince a reasonable person that there is a direct relationship between the non-performance and the harm suffered by the creditor.

iii.* Consider the following statements by M. Pothier. *"Damages and interests are the loss which a person has sustained, or the gain which he has missed; … Therefore, when it is said that the debtor is liable for the damages and interests resulting from the nonperformance of the obligation, it is to be understood that he ought to indemnify the creditor from the loss which the non-performance of the obligation has occasioned to him, and for the gain of which it has deprived him… The debtor however is not to be subjected to indemnify the creditor indiscriminately for all the loss which may have been occasioned by the non-performance of the

obligation, and still less is he answerable for all the gain which the creditor might have acquired, if the obligation had been satisfied. A distinction must be made in this respect, between different cases, and different kinds of damages and interests, and a certain degree of moderation ought also to be applied, in estimating those for which a debtor is liable." **Relate this statement to the above-stated provisions of the Civil Code.**

LECTURE NOTES ON THE LAW OF CONTRACTS

No. 4

ON EXTINCTION OF OBLIGATIONS

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I. **MEANING AND RATIONALE:- Because nothing is eternal, obligations created or varied in a contract come to an end at a certain point in time**

or upon the occurrence of certain events, whether envisaged or otherwise. Contractual obligations thus have their ends in as much as they have their beginnings, just as in any other natural or social phenomenon. In the Civil Code too, a contractual obligation may be extinguished by performance (Arts. 1740 – 62); by invalidation or cancellation Arts. 1808 – 18) *cum* (1784 – 89); by termination (Arts. 1719 – 24); by remission of debt (Art. 1825); by novation (Arts. 1826 – 30); by set-off (Arts. 1831 – 41); by merger (Arts. 1842 – 44); and by limitation of actions (Arts. 1845 – 56). Some of these grounds may take place in a mutually favorable manner. Such are grounds of extinction by performance, by novation and by set-off. Others may be detrimental to one of the parties. Invalidation and limitation of actions may be grouped in this category. Still others take place on different economic, social or moral grounds. Included in this category are extinction on the grounds of remission of debt, termination and merger.

II. <u>PERFORMANCE</u>:- This is the most healthy mode of extinction as it implies the actual accomplishment of a duty which one committed himself to do. Details have already been outlined in Notes No. 3 above.

III. <u>INVALIDATION AND CANCELLATION</u>:- (Arts. 1808 – 18)

a. The cause of invalidation is defect in contract formation. When a contract does not stand the test of formation espoused by the law, it is either void (null) or voidable (can be subjected to nullity). This could be absence of capacity of one of the parties; vice in consent; illegality or immorality of the object; or failure to abide by formal requirements of conclusion when such form is prescribed by the law.

b. The meaning, grounds and effects of cancellation have already been described above (See Notes No. 3). The idea of invalidation is very much based on the theory of void and voidable juridical acts.

i. A void act is an act that is totally devoid of any effect in the eyes of the law. Some jurisdictions go to the extent of arguing that a void act is an act that is deemed never to have taken place, a nullity in law. In the words of G. W. Paton, "If the defect is such that the act is devoid of the legal results contemplated, then the act is said to be void". One cannot uphold the value of these acts by any means as they are *void ab initio.* As goes the old adage of Roman Law – *Ex dolo molo non oritur actio,* the law should not lend its hand to someone with a claim based on a cause the law deems void. Nothing can cure an instrument or a transaction that is nugatory or ineffectual.

ii. On the other hand, a void act is an act susceptible to invalidity but can be remedied by the party entitled to destroy it. In the law of contracts, it is an imperfection or defect in formation that can be cured by the act or confirmation of him who could take advantage of it. The fate of the obligation is thus dependant on the will and whim of the party affected. He may retain its validity or seek its invalidation.

c. In the Civil Code, the principle of the law on void and voidable contracts is espoused under Art. 1808. Sub-Art. 1, which is on voidable contracts, states that "*a contract which is affected by a defect in the consent or by the incapacity of one party may only be invalidated at the request of that party".* Whereas, Sub-Art. 2 on void contracts provides that *"a*

contract whose object is unlawful or immoral or a contract not made in the prescribed form may be invalidated at the request of any contracting party or interested third party".

d. In the case of a voidable contract, the party entitled to invalidate; and in the case of a void contract any one of the parties may refuse to perform the contract when he is required to do so by the other party (Art. 1809).

e. The provisions on time to take action for invalidation, on reparation of harm in the case of unconscionable contracts and on duty to state one's intention to invalidate (Arts. 1810 – 14) are self-explanatory.

f. The effect of invalidation, and also of cancellation, is restoration of parties to the contract to their previous positions. This is what the law refers to as reinstatement. In both cases, the law requires for parties to be restored, as far as possible, to the position and status they had been before conclusion of the contract. Properties delivered shall be returned; monies paid shall be given back; and works done in pursuance of the contract shall be undone. The rationale behind reinstatement, restitution in some legal literatures, stands on the equitable remedy that states thus: "a person who has been unjustly enriched at the expense of another is required to make reinstatement to that other. If reinstatement is not a feasible option, the party adversely affected is entitled to seek damages from the other, including the right to demand reimbursement of all expenses incurred in due course. Reinstatement may not be a feasible option where, for example, the property delivered to the buyer in a contract of sale is destroyed, is transferred to a third party in good faith and by lawful means, or the one

liable to reinstate cannot do so for good cause. (See Arts. 1815 – 18)

IV. <u>TERMINATION</u>:- (Arts. 1819 – 24)

a. **Termination is one means of bringing an end to a contract before it is fully or partially performed as agreed. In the ordinary course of events, the right to extinguish a contractual obligation by agreement is the natural corollary of the right to conclude a contract.**

b. **It could take place by the mutual agreement of the parties or unilaterally. Where mutual, the source is the independent agreement of the parties to cause its termination. Where unilateral, the source may be a termination clause inserted in the original contract, the indefinite duration of the contract or the disappearance of the relationship of trust and confidence that existed between the parties at the time of concluding the contract or any other ground prescribed by the law.**

c. **Acts done after the conclusion of the contract but prior to its termination do, however, remain valid. This implies that termination does not bring about the duty of reinstatement *per se.* This is primarily meant to protect rights of third parties who might have transacted with one of the parties on the subject matter of the contract.**

V. <u>REMISSION OF DEBT (RELEASE)</u>: (Art. 1825)

a. **Remission of debt has the effect of extinguishing a contractual obligation when the creditor fully releases the debtor of its obligation to perform the contract. It is a gratuitous move by the former that extinguishes the obligation.**

b. **For business, personal or other reasons, however, the debtor may refuse the remission in which case the obligation revives. That could be the reason for inserting the phrase *"unless the debtor forthwith informs the creditor that he refuses his debt to be remitted".***

c. **Pothier advances a slightly different approach to the issue of remission of debt in his gift theory of release. In his words: *"Where a creditor declares that he makes a release to his debtor of his debt, he should not be presumed to have the absolute intention of abdicating his demand, but rather that of making a gift to his debtor. Now, as every gift requires the acceptance of the donatory, it should be held that the creditor only intended to abdicate his right of credit, upon his release and gift receiving their perfection by the acceptance of the debtor… ".* Compare this statement to the provisions of Art. 1825 and Art. 2436/1 which prescribes as follows: *"A contract of donation shall not be complete until the done has expressed his intention to accept the liberality."***

VI. NOVATION:- (Arts. 1826 – 30)

a. **Some basics:- What is it? What are its forms? What debts may be subject to novation? Who may make a novation? How may it be made? What are its effects? Generally speaking, novation is an agreement for substitution of a new debt for an old one. This brings about the extinction of the old debt.**

b. **The two are different in their object or their nature but are intertwined by a cause and effect relationship. They are related in process but are different in essence. Extinction of the old obligation is the cause for the coming into**

picture of the new one. In other words, creation of the new obligation is <u>the effect</u> of the extinction of the new one.

c. **Minor variations in the contents of the contract in terms of timing, conditions or privileges do not amount to novation.**

d. **All securities and privileges attaching to the old obligation such as guarantees, pledges or mortgages do not transfer to the new obligation. To do so, parties need to expressly agree for incorporation of these privileges in the new contract.**

e. **Parties, however, remain unchanged.**

VII. <u>SET-OFF (COMPENSATION)</u>:- (Arts. 1831-41)

a. **<u>Principle</u>:- Two persons may be creditors of each other on the basis of two separate obligations. The debts due to one another may be contractual or non-contractual. In this case, one may normally set-off his claim with a separate claim brought against him by another. <u>Compensation</u>, as it is sometimes referred to, argued Pothier, is *"the extinction of debts of which two persons are reciprocally debtors, by the credits of which they are reciprocally creditors".* It used to be espoused by the ancient Roman precept: *"<u>Compensatio est debiti et crediti, inter se contributio"</u>.***
   i. **Where the debts are of equal value, the obligations of both do extinguish.**
   ii. **Where they are unequal, the smaller is extinguished and the greater is reduced by the value of the smaller one.**

b. **Conditions for set-off:**
   i. **The obligations should be money debts, fungibles or quantifiable in monetary terms.**

ii. **The obligations must be certain.**
iii. **They must be due.**

c. **Obligations not susceptible to set-off:**
   i. **Special kinds of obligations such as maintenance, alimony and, in some ways, wages due to employees.**
   ii. **Debts due to the state.**
   iii. **Obligation to restore unduly taken property or money.**
   iv. **The obligation to return money that is deposited.**

d. **In most cases, set-offs take place by mere arrangement of the parties there being no need to resort to a third party arbiter. At times, though, it may be expressly agreed by the parties by means of a set-off clause.**

e. **Court may intervene in this arrangement under exceptional circumstances provided by Art. 1841.**

VIII. <u>MERGER (CONFUSION)</u> (Arts. 1842 -1844)

a. **By merger is meant the concurrence of two capacities in the same person that destroy one another. It is the fusion of the character of debtor and creditor of the same debt in the same person. Three possible instances are worth considering here:**
   i. **<u>Succession</u>: When the debtor succeeds his creditor; or when the creditor succeeds his debtor; or when a third party succeeds both the creditor and the debtor as a sole heir.**
   ii. **<u>Merger of personal property in matrimony</u>: When a man and a woman who had been debtors and creditors of one another agree to get married and merge their entire patrimonies in one by a contract of marriage.**

iii. **<u>Merger of two business entities</u>. When two corporate entities who had been debtor and creditor merge as single entities; or one of the entities is absorbed by the other; or when both are taken over by a third entity.**

b. **As one cannot be his own debtor or creditor such occurrences bring an end to the obligation. However, merger should not operate to the detriment of third parties' interests.**

IX. <u>LIMITATION OF ACTIONS (Arts. 1845 – 56) AND PRESCRIPTION</u>

a. **As seen from the view point of the law of obligation, limitation of action refers to the life of a legal action to claim a right *in personnam.* It is a formula developed by the legal mind to induce a creditor to exercise his right within a certain span of time, while it is at same time a means of relieving the debtor of his obligation should the creditor fail to bring the action within that given time. That is why such an action is sometimes referred to as <u>liberative prescription</u> since the beneficiary of time in these cases is always the debtor. It is thus regarded as the expiry of right. Because it extinguishes the obligation short of performance, it is also described as <u>extinctive prescription</u>.**

b. **The other kind of prescription is the one we find in the law of property, which is designated as <u>acquisitive prescription</u>. While liberative prescription operates to deprive the holder of a right of his law claim if does not exercise it within the time frame set for so doing, this one entitles a person who did not have a right over a certain piece of property after the lapse of a certain time. In other words, one who makes continuous and unabated use of the property**

for a defined period of time and fulfills certain legal and administrative formalities becomes the owner thereof. The most typical example in the Civil Code is the rule provided under Article 1368. It reads thus: *"<u>Usucaption:</u>- The possessor who has paid for fifteen consecutive years the taxes relating to the ownership of an immovable shall become the owner of such immovable…"*

c. **<u>Consider the following statement of G. W. Paton on the rationale of prescription.</u> *"…two questions may arise: why should the law prohibit actions for redress after a certain space of time? Why should continued possession (even when it is wrongful) be effective to defeat the right of the true owner? The answer to the first question is that the law aids the vigilant and not the slothful… In truth the whole doctrine, like that of prohibiting actions after a certain length of time, is based on broad views of policy. It is unsettling to allow no time limit to legal claims and indolence brings its own reward. The small percentage of cases in which there may be injustice is outweighed by the legal interest in establishing security…"***

d. **Prescription is either based upon a presumption of payment (See Arts. 2020 – 2026) or release by operation of the law arising out of failure by the creditor to enforce his right within a period of time set forth by the law. Some writers also argue that it is used as a punishment for the negligent of a creditor. The law having given him time to take action against the debtor, his claim ought not to be sustained if he causes that time to lapse.**

e. **As can be seen from Art. 1845 contract actions that may be barred by limitation are:**

- ***i.*** **Actions for performance of a contract;**
- ***ii.*** **Actions based on non-performance of a contract; and**

iii. **Actions for invalidation of a contract. (Compare, though, this last action with Art. 1810.)**

iv. **In general, the time when prescription begins to run is the period when the obligation of the debtor becomes due. A prescription cannot, therefore, be considered to run against the creditor during the time the debtor is not bound to perform or before the occurrence of a condition precedent that suspends the right of the creditor to take appropriate action. This was also the case in the old Roman law adage of *contra non valentum agere nulla curit prescriptio.***

f. **Normally the period prescribed by the Code for actions based on contract rights is ten years. But other provisions that pertain to special contracts or to non-contractual obligations may specify different time frames, in which case the ten year period may not be applicable. (See in this connection Arts. 1676 and 1677 for application of rules on general contracts to special contracts or to non-contractual obligations.) For computation of the time and related matters see Arts. 1847 – 50.**

g. Interruption (Arts. 1851 and 1852) implies any act by which the debtor acknowledges the debt or the creditor. This could be in the form of partial payment of the principal claim or its interest; tendering of a personal guarantor, or production of pledge or mortgage to the creditor. The creditor may also interrupt the limitation period by bringing a legal action against the debtor. The effect of interruption is to cause the commencement a fresh period of limitation on the same subject matter

h. The exceptions:- Special relationship between the parties may be a justification a creditor may avail himself of for not observing the prescription period. The relationship may be

based on familial bonds, on respect and reverence to one's debtor, or on subordination. (Art. 1853)

i. **<u>Waiver</u>:- Limitation is a right the law accords to a debtor which cannot be waived in advance. Parties are not at liberty to Agree that rules on limitation of action may not apply to their contract should one of them fail to perform its obligations therein. Nor can they agree to reduce the time below the one set by the law. Notwithstanding this rule, however, a party may waive his right to invoke prescription after the time for exercising it has become due. Another important point to be taken into account is that courts cannot have regard to limitation unless pleaded by the party having the right to do so. (Arts. 1854 and 1855)**

j. **Limitation in other areas of the law**
   i. **Tort (Art. 2143)**
   ii. **Successions (Arts. 973, 974 and 2001)**
   iii. **Usurpation (Art. 1149)**
   iv. **Contract of carriage (Com. C. Arts. 603 and 642)**
   v. **Insurance (Com. C. Art. 674)**
   vi. **Negotiable instruments (Com. C. Arts. 807, 817, 855, 881)**
   vii. **Labour Proclamation (different time frames for bringing actions for reinstatement, for payment of wages and for compensation)**
   viii. **Tax law.**
   ix. **Execution of judgment (Civ. P. C. Art. 384)**
   x. **Criminal Code (On prosecution and on sentencing)**

No. 5
ON SPECIAL ISSUES RELATING TO OBJECTS OF CONTRACTS
Tilahun Teshome (Prof.) 2012 -2013 A.Y.

I. PRELIMINARY POINTS

a. **The doctrine of freedom of contract has it that parties have full measure of autonomy to determine the subject matter of their contract. This is only subject to limited exceptions imposed by the law in consideration of the general public interest. See Civ. C. Art. 1711.**

b. **Questions such as: With whom to conclude a contract? How to conclude? What its terms and conditions may be? In what ways should the obligations be performed? What additional means of guaranteeing performance should be ensured? What civil sanctions should be imposed on a recalcitrant? What form should communications of the parties assume? In what ways may disputes stemming from the contract be resolved? And similar others are, by and large, left for the parties to regulate.**

c. **The purpose of the law is to lay down general guidelines that are meant to help parties when they contemplate of concluding contracts. The provisions of the law are mostly permissive in nature in the sense that they can be derogated from by the parties.**

d. **Some of these provisions are the ones that we find under Chapter Four of Title Twelve of the Code (Arts. 1857 – 1895), with separate sections on Terms, on Conditions, on Alternative Obligations, on Earnest and on Provisions as to Liability.**

II. TERMS IN CONTRACTS (Arts. 1857 -1868)

a. **Terms of contract relate to the time span in which parties bind themselves to perform their obligations under a contract. Term is thus generally a space of time granted to the debtor to perform his obligations.**

b. **It goes without saying that a contractual obligation can be assumed with or without a term for discharging it. In most contracts that we conclude in our day-to-day lives, without even having the knowledge that we are doing so, the obligations of the parties are discharged simultaneously. As Pothier explains, "an obligation is either contracted with a term for discharging it, or not: when it is contracted without a term, the creditor may require it to be discharged immediately; when it includes a term, he cannot require it until the term is expired".**

c. **Where there is no term, both parties carry out their obligations when the transaction takes place. This does not, however, imply that all contracts without a term shall be performed as and when sought. The nature of the obligation assumed by the debtor or the place of performance may make it incumbent upon the creditor to give reasonable time to the debtor to enable him discharge his obligation. Such, for example, is the case of a construction contract or that of a transport arrangement. The contractor needs reasonable time to complete his work depending on several factors such as the time required to be spent on each phase of the construction work, availability of materials and facilitation of administrative and regulatory procedures. The transporter, likewise, needs reasonable time to take an object from one place to another.**

d. When there is a term, though, he who has not discharged his obligation fully or in part at the time of conclusion of the contract may avail himself of the benefit of time stipulated in the contract. (Art. 1865) Either of the parties may be beneficiaries of term, depending on the level of performance of each one's obligations. Under exceptional circumstances, even the creditor may benefit from time. See Art. 1867.

e. Waiver of benefit of time. The debtor may perform the contract even before the time set for so doing runs unless the contract compels him not to do so in the interest of the creditor. But he cannot be forced to discharge it so long as his obligation has not matured. Art. 1866. Payment made before the date stated in the contract, however, is not recoverable by the paying debtor since it brings an end to the contract.

f. A term may be express or implied.
- **i. It is express when a clear stipulation to that effect is made in the instrument in which the K is drawn up.**
- **ii. It is implied when, as pointed out above, the nature of the obligation assumed by one party or both is such that it requires a fairly reasonable time for its consummation.**

g. A term may likewise be either of right or of grace.
- **i. It is a term of right when it is agreed that the contract will be carried out within a specified period of time.**
- **ii. It is a term of grace when a creditor, the law or a judge gives the debtor additional time to discharge his obligations. See Civ. C. Art. 1770.**

h. Insolvency of the debtor or other inappropriate acts committed by him may bring an end to his right to benefit from time.

i. For the different modes of computation of contract time, see Arts. 1852 -1863.

III. CONDITIONAL CONTRACTS

a. In the ordinary course of events, a conditional obligation is one the performance of which depends on the occurrence (positive condition) or the non-occurrence (negative condition) of an uncertain event that is beyond the control of the parties. (Art. 1869).

b. To constitute a condition, the fact must be future and uncertain. Uncertainty of the condition should not also be subject to the will of the parties to make it happen or to prevent its happening. If so it becomes potestive, or unbalanced, and nullifies the agreement on the condition and, at times, the contract itself. (Art. 1879) See also the provisions of Arts. 916 – 919 for suspensive and resolutive conditions in a testamentary legacy.

c. As in all other aspects of contractual objects, the condition should likewise be lawful, possible and should stand the society's test of morality. (Art. 1878).

d. Conditions are classified as conditions precedent and conditions subsequent.

i. In a condition precedent, the condition must precede in order for the obligation to be performed. Condition precedent is also called suspensive condition since performance of the contract is suspended until such time that the uncertain event materializes. (Art. 1871) It is a condition

that should be met to the vesting of any liability on the other party to perform his part of the obligation.

ii. In a condition subsequent, the condition brings an end to the validity of the contract. Obligation is valid only until the occurrence or otherwise of the stipulated condition. It is sometimes referred to as a <u>resolutive condition</u> as its occurrence or non-occurrence halts performance, thereby extinguishing the obligation. (Art. 1872). It is some fact or event other than performance itself which the contract provides shall relieve a debtor of his obligation.

e. The place of good faith in conditional contracts. (Arts. 1870 and 1873). As conditions in a contract are treated as uncertain and future events, parties should not prevent the occurrence or otherwise of the events contemplated therein. Nor should they be responsible for their materialization. The party who does so will be responsible for the damages that the other party sustains as a result. Insurance contracts are typical examples in this regard.

f. Acts of management and acts beyond management. (Arts. 1874 and 1875). Unless done in good faith, such acts remain valid even if they are done prior to the occurrence of the condition.

IV. <u>ALTERNATIVE OBLIGATIONS</u> (Arts. 1880 – 1882)

a. Alternative obligations envisage situations in which the debtor may perform any one of several obligations. Unless the contract provides otherwise or the debtor himself waives this right, the choice is always left for

him. Performance of any of them relives him of his responsibility in the contract.

b. But debtor cannot perform part of this and part of that obligation.

c. It can also be stipulated that the choice is to be made by the creditor or by a third party for whose benefit the contract is concluded. In that case, the creditor or the third party beneficiary has the same right the law accords on the debtor.

d. Where performance of one of the obligations is impossible, the debtor may perform the other unless he is at fault in which case the other party may claim damages for losses that he suffers as a result.

V. EARNEST (Arts. 1883 -1885)

a. Although the law does not clearly provide that, earnest is a sum of money paid by a buyer to a seller to show his seriousness to consummate the transaction.

b. If the contract is concluded as earlier agreed, the earnest money is considered as part of the price.

c. But in K with earnest any one the parties may bring an end to it. The party who paid the money may do so by forfeiting the earnest sum to the recipient and the party who received the money may similarly do so by giving double the earnest sum to the payer. This is what differentiates earnest from a down payment. In the latter case, the K cannot be cancelled unless there are justifiable grounds for so doing.

LECTURE NOTES ON THE LAW OF CONTRACTS
No. 6
ON SOLIDARY OBLIGATIONS

Tilahun Teshome (Prof.) 2012 – 2013 A.Y.

I. INTRODUCTION

a. Scope of solidarity obligations

i. **Contracts, as we know, presuppose a debtor/creditor relationship. In other words, they require plurality of actors. Art. 1675. Expressions such as obligor/obligee and promisor/promisee are also employed to designate the same idea.**
ii. **In all commutative contracts, both parties may be called debtors and/or creditors depending on the level of performance of the contract at any given time.**
iii. **In most contractual dealings, the parties are a single debtor and creditor. Bilateralism.**
iv. **But this is not always the case as it is also possible for any contract to have several debtors and/or creditors. Multilateralism.**

b. Terminology

i. **Joint and several liability and/or debtors**
ii. **Solidary obligations and/or obligors**
iii. **Joint and several promise and/or promisors**
iv. **Joint and several right and/or creditors**
v. **Solidary right or claim**
vi. **Simple joint obligations**
vii. **Subscription contracts**

c. Principles of solidarity

i. **Solidary obligations arise from the existence of several debtors that are**

obliged by a single obligation/promise. The debtors are bound to the creditor/creditors on the same obligation/promise that is normally created under a single instrument.

ii. **Solidary rights stem from the prevalence of several creditors in a single right/claim. The creditors are entitled to a single right/promise that is normally created under a single instrument.**

iii. **Simple joint obligations arise in a situation where a single instrument contains several debtors in which each one of the debtors is only liable to his/her part of the debt.**

iv. **In case of solidary obligations and/or rights, there is a two-sided legal relationship.**

    1. **The relationship between the solidary debtors as a group and the creditor; or in the event of solidary rights, the relationship between the solidary creditors as a group and the debtor. This is the primary relationship where the rule of solidarity operates.**
    2. **The relationship amongst the solidary debtors and/or creditors themselves. This is the secondary relationship in which the rule of solidarity does not normally operate.**

v. **Simple joint obligations and/or rights constitute a one-sided relationship only. That is, the relation between the simple joint debtors individually and that of the creditor; or the relationship between the simple joint creditors individually and that of the debtor. A single debtor does not answer for the debts of other debtors; and a single creditor does not claim the shares of other creditors.**

vi. **The higher the number of debtors and/or creditors in solidarity, the more complex**

the relationship becomes. But this is not the case in simple joint obligations/rights.

d. Modalities of plurality
  i. Solidary
    1. Several debtors v. the creditor.
    2. Several creditors v. the debtor.
    3. Several debtors v. several creditors.
  ii. Simple: Same as in the case of solidarity but with different options for recourse.

e. The driving principle of solidarity is convenience of the creditor in the realization of his/her claim from the debtor/debtors.

II. SOLIDARY DEBTORS (Civ. C. Arts 1896 – 1909)

a. Solidarity between debtors consists in the fact that the creditor is entitled to initiate legal actions for the recovery of his claim from any one, some or all of the debtors until such time that the obligation is fully discharged. A debtor may not avail himself of the defense of benefit of division as is the case for simple joint debtors.

b. The creditor has as many actions of recourse as there are debtors including the number of possible combinations between the debtors in whole or in part.

c. The principle of presumption of solidary obligations has it that unless the instrument expressly provides otherwise, joint debtors are always solidarily liable. Art 1896. Not all legal systems even within the Civil Law legal family do, however, subscribe to the rule of presumption of solidarity. Art. 1202 of the Civil Code of France, for example, specifies that there is no presumption in favor of solidary obligations.

d. **Because the extent of liability of each co-debtor is not limited to his share of the debt, there is an implied guarantee between the co-debtors as far as meeting the claims of the creditor is concerned. For his share of the debt, each co-debtor is regarded as a principal debtor while he is regarded as joint guarantor with no recourse to the defense of benefit of discussion for the shares of the other shareholders.**

e. **Sources of solidary obligations.**
   i. **Contract where there is multiplicity of debtors in a single performance.**
   ii. **The law. E.g. Joint tortfeasors, co-offenders, persons bound by negotiable instruments, joint heirs, debtors jointly liable for maintenance.**
   iii. **Acts of third parties. E.g. Charges in wills**
   iv. **For operation of the rules of joint and several liability in some other areas of Ethiopian law, see the following provisions. Civ. C. Arts. 323-326, 458,507-515, 714, 919, 2086, 2126, 2129, 2130, 2155, 2156, 2195 and 2225. Comm.C. Arts. 255, 280, 286, 301, 308, 309, 342 and 366.**

III. EFFECT OF SOME LEGAL DEFENSES ON SOLIDARY OBLIGATIONS.

a. ***Res judicata*** **(Civ. C. Art. 1898 and C.P.C. Art. 5). Proceedings instituted against one debtor may not prohibit the creditor from resorting to other creditors.**

b. **Notice: Placing one debtor in default amounts to placing all others in the same. Art. 1899 *cum* Arts. 1772 1775. All effects such as computation of interest, transfer of risk and interruption of period of limitation do hold good for other co-debtors in as much as they do with the one on whom notice is served.**

c. **<u>Nullity:</u> Art. 1900 *cum* Art. 1808. If the contract is void, all co-debtors may avail themselves of the defense of nullity and may refuse performance; if is voidable, though, only those debtors affected by the vice may do so.**

d. **<u>Payment and limitation:</u> Art. 1901 *cum* Arts.1740 – 1762 and Arts. 1845 – 1856. All co-debtors may invoke defenses based on full or partial performance or on limitations of actions.**

e. **<u>Remission of debt:</u> Art. 1902 *cum* Art. 1825. Remission of one co-debtor amounts to remitting all unless made specifically in favor of that debtor. In this case, the share of the debt of the other debtors is reduced to the extent of the amount remitted in favor of that particular debtor. (See the Amharic version, the English is not correct.) Unless there is an agreement to the contrary, shares are presumed to be equal.**

f. **<u>Novation:</u> Art. 1903 –*cum* Arts. 1826 -1830. Same as in Remission.**

g. **<u>Set-Off:</u> Art. 1804 *cum* 1831 -1841. Co-debtors may invoke the defense of set-off against the creditor only to the extent of the amount of their indebtedness. Again, the Amharic version is much better in terms of clarity.**

h. **<u>Merger:</u> Art.1805 *cum* 1842 -1844. The share of the co-debtor whose interest is merged with that of the creditor may be reduced from the total debt. Here again the English version has a problem.**

IV. <u>RELATION BETWEEN THE CO-DEBTORS. - Arts. 1906 -1909.</u>

a. **A co-debtor should refrain from acts that increase the liability of other co-debtors.**

b. **A co-debtor who has paid more than what he was actually supposed to pay as his share has the right to seek contribution from the other co-debtors.**

c. **For the claim of the paying co-debtor, however, there is no presumption of solidarity as each debtor is only liable to his share of the debt.**

d. **If one of the co-debtors cannot pay his share, his part shall be apportioned amongst the other co-heirs.**

e. **Unless agreed otherwise amongst the co-debtors, shares in the debt are presumed equal.**

V. SOLIDARY CREDITORS – (Arts. 1910 -1916)

a. **Solidarity between creditors consists in the fact that any one of the several creditors may proceed against the debtor/debtors to realize the whole claim, or a part thereof at his pleasure. It is also possible for some or all of the creditors to jointly proceed against the debtor/debtors. A debtor against whom an action is instituted for the recovery of the whole claim, by one or some of the creditors, may not avail himself of the defense of benefit of division so that the creditor divide the claim and proceed only for his share.**

b. **The number of recourses available for creditors is dependant on their number, their combinations and their totality put together.**

c. **Unlike solidary obligations, solidary rights are not presumed. The instrument that created solidarity of creditors is always required to**

clearly show prevalence of solidarity in order for the creditors to enjoy this right. Art. 1910.

d. **Because the right of each creditor in solido is not limited to his share of the total claim, there is an implied mandate between co-creditors in as far as their right to claim against the debtor is concerned. For his share of the claim each co-creditor is regarded as the principal creditor and for the shares of the other creditors, he is considered as an agent.**

e. **Performance/payment made in part or in whole to one of the creditors is effective against all the other creditors.**

f. **Unless expressly instructed by one or some of the creditors otherwise, the debtor is at liberty to pay/perform to any one of the joint creditors. Arts. 1911(3) *cum* Art. 1743, C.P.C. Art. 293.**

g. **Sources of joint and several right are mainly contracts and sometimes testamentary legacies. But no instances of the law being source of a solidary right unlike in the case of solidary obligations.**

h. **A Solidary right is the less common phenomenon of the two.**

i. **Effects of some legal provision on solidary rights:**
    i. **Interruption of statute of limitation – Art. 1912 *cum* Arts. 1851 and 1852. Interruption by one creditor benefits all.**
    ii. **Remission of debt made by one co-creditor does not affect the others, Art. 1913.**
    iii. **Novation by one co-creditor does not affect the rights of other co-creditors. Arts. 1914.**

iv. **Set-off by the debtor against one co-creditor does not affect the other co-creditors. Art. 1915.**

j. **Relationship between co-creditors.**
   i. **<u>Presumption of equality</u> of shares unless agreed otherwise.**
   ii. **A creditor who received more than his shares shall account for the excess to the other co-creditors.**
   iii. **There is no solidarity between the other co-creditors in their claim against the receiving co-creditor.**

VI. <u>SIMPLE JOINT OBLIGATIONS (NON-JOINT OBLIGATIONS).</u>

a. **Plurality of debtors and/or creditors alone does not always bring about solidary obligations and/or rights. Contracts having plurality of parties with separate and defined obligations/rights may not be regarded as having joint obligations/rights even if made in one instrument. <u>Arts. 1918 and 1919.</u>**

b. **In simple joint obligations, there are <u>as many contracts as there are debtors or creditors</u> despite the fact that these contracts stem from the same instrument.**

c. **Each debtor is only liable to his corresponding debt and so is each creditor. These kinds of contracts are sometimes known as <u>prescription contracts</u>.**

d. **A debtor sued for more than his share in the contract has the right to invoke the defense of <u>benefit of division</u>.**

e. **The creditor may initiate an action by joining the debtors in accordance with the relevant**

provisions of the C.P.C. but in doing so he is required to show the debt of each defendant separately. Joinder of actions but not unity of obligations.

f. **Where the nature of the obligation is indivisible by operation of the law or by the nature of the debt, simple joint obligations may sometimes be regarded as joint obligations. Art. 1917. These are what are sometimes known as indivisible obligations, e.g. the obligation to construct a house or to deliver a horse on the basis of a simple joint obligation.**

LECTURE NOTES ON THE LAW OF CONTRACTS
No. 7
ON SURETYSHIP

***Tilahun Teshome (Prof.),* 2012 -2013 A.Y.**

I. THE NEED FOR AND MEANING OF SURETYSHIP

a. **The general principle in the law of obligations has it that the property of a debtor is the pledge of his creditor (general security). See Civ.C Art. 1988(1) and Civil Procedure Code Arts. 151 and 154 (attachment before judgment). But in the real world, this is not always the case due to the following and similar other reasons.**
    i. **Insolvency/bankruptcy of the debtor**
    ii. **Multiplicity of creditors**
    iii. **Improper conducts of the debtor**
b. **Suretyship is thus a means of minimizing the risks that may befall on a creditor on account**

of the inability of the debtor to perform his obligations. Normally, the risk of insolvency of a debtor is to be borne by the creditor. But in suretyship, this risk is mitigated by bringing in some other person into the obligation

c. **In business and economic terms suretyship is a <u>risk management</u> device; whereas in legal parlance, it is a <u>subsidiary contract</u> stemming from the principal one. It is also referred to as <u>personal guarantee</u>.**

d. **Other modes of security device in the Civ.C include pledge, mortgage and antichresis. See Arts. 2825 – 2874 for pledge, Arts. 3041 – 3116 for mortgage, Arts. 3117 - 3130 for antichresis and Arts. 171 – 173 of the Comm.C. for business mortgage.**

e. **Distinction between <u>insurance, warranties and suretyship</u>.**
   i. **<u>Insurance</u> is an independent contract between the insurer and the client to cover the agreed upon insurable interests of the insured or a third party for whose benefit the contract is concluded; (See Comm.C. Art. 654) whereas a suretyship is a subsidiary contract the validity of which, by and large, depends on the validity of the main contract.**
   ii. **Warranty is just a term in a contract or a stipulation of the law (See, for example, Civ.C. Arts. 2281 – 2289) that would provide an additional protection for the performance of a contract; while in suretyship the additional protection is provided by another contract that brings in the surety to the relationship.**

f. **Suretyship is thus an undertaking whereby a person obligates himself to stand for the debt of another in the event of the latter's failure to**

pay. In the words of M. Pothier, the 18th Century jurist whose ideas were largely incorporated in the 1804 *Code Civil* of France, suretyship is :

> ***a contract, by which a person obliges himself on behalf of a debtor to a creditor, for the payment of the whole, or part of what is due from such debtor, and by way of accession to his obligations.***

g. The undertaking assumes <u>two obligations</u> and <u>three parties</u> (a triangular contract). The <u>primary obligation</u> is the one between the creditor and the principal debtor, while the <u>secondary one</u> is that between the creditor and the surety. The parties are the <u>creditor, the principal debtor and the surety</u>.

h. <u>The source</u> of the principal obligation may be contractual or extra-contractual while that of the suretyship is always contractual. The Difference between <u>suretyship and bail bond</u> in criminal law is also an issue to take note of.

i. The law of suretyship thus attempts to provide answers to such questions as <u>for whom, in whose favor, for what kinds of obligations and in what manner</u> a contract of suretyship is to be concluded. It also regulates the relationship between a creditor and a surety, a surety and a principal debtor and relations between several sureties, if there are any.

j. The Civil Code makes use of the terms <u>suretyship and personal guarantee interchangeably</u>, while there are some differences between the two in other legal systems. At common law, for example, a surety is jointly and severally liable with a principal debtor while a guarantor is one who is secondarily liable in the event of default of the principal debtor.

II. MAIN FEATURES OF SURETYSHIP

a. **Suretyship is a benefactory contract. The surety does not normally require consideration from the principal debtor. The fact that a surety may be given with or without the consent or the knowledge of the principal debtor (Art. 1921) is an indication of this fact. But the surety and the principal debtor may, at their pleasure, agree to provide some kind of consideration for the surety although such agreements do not in any way affect the right of the creditor against the surety. Such agreements create two separate rights in favor of the surety.**
   i. **To claim from the debtor what he has paid to the creditor.**
   ii. **To claim the value of the consideration for the surety.**

b. **Suretyship is an accessory obligation. Its existence and validity is dependant on the existence and validity of the main contract. (Arts. 1923/1 and 1926/1). The extinction in any form of the primary obligation extinguishes the obligation contained in the suretyship. There are, however, exceptions to this general rule where the primary obligation is voidable as is the case under Arts. 1923/3 and 1926/6.**

c. **It is required to be clear and unequivocal as the obligation of suretyship is not presumed. This shows that the standard of proof in the event of surety is much stronger than other forms of contract. It is also expected to be made in writing, be express and should not be meant to go beyond the contractual limit, which again is necessary to be stated in the contract. (Arts. 1922, 1725/a and 2003). At Common Law too, suretyship is a form of obligation required by the Statute of Frauds to**

be made in special form. It is what is termed as "a special promise to answer for the debt, default or miscarriage of another person".

d. **Suretyship is an obligation that is not more onerous than the primary obligation. It should not be made on terms that are more burdensome than the latter. Where such is so, the excess is reduced to the limit of the primary obligation. After the making of the contract, the creditor and the principal debtor may not conclude a contract that would increase the liability of the surety. Even the time agreed for performance of the obligation may not be changed or elongated without the express consent of the surety. (Arts. 1924 and 1928)**

e. **Suretyship pertains to a specified amount of obligation. It is invalid unless such amount is clearly stated in the instrument that created the surety. Even if it is given for future or conditional obligations, it is of no effect unless the maximum amount of the surety is expressly stipulated. If the time for the duration of the liability is not stated in the contract, the surety may bring an end to his obligation so long as performance of the obligation is not due. (Arts. 1922/3 and 1925).**

f. **Suretyship is an undertaking specifically given by the surety to the creditor. No other person may avail himself of this right unless the creditor has validly assigned the same to this third person. (Art. 1920)**

III. RELATIONS BETWEEN THE CREDITOR AND THE SURETY

a. **Traditional defenses. The surety may invoke all the defenses that are personal to the principal debtor such as statute of limitation,**

benefit of time, payment, nullity of the primary obligation, notice and remission of debt made in favor of the debtor. He may also invoke grounds that would make the very suretyship null and void. These are known as traditional defenses. See Arts. 1923, 1926 and 1927.

b. The benefit of discussion (*beneficium ordinis seu excussionis)* (Arts. 1934 -1937)

- **i. The surety may require the creditor to first proceed against the debtor prior to resorting to him.**
- **ii. The right to the defense of benefit of discussion is, however, a matter that requires to be pleaded by the surety as he is proceeded against. If it is not invoked at the time of the suit, it is deemed waived. (Art. 1935) This is similar to points of preliminary objection under Art. 244 of the C.P.C.**
- **iii. Surety is also required to adequately describe the assets of the principal debtor against which the creditor may take actions. The assets to be discussed are likewise required to be unencumbered by other creditors and not to be out side the judicial jurisdiction of the court. In addition, the surety is duty bound to advance sufficient money to cover the cost of the discussion.(Art. 1936)**
- **iv. The two advantages of discussion. (Art. 1937)**
  1. **Deferral of judgment against the surety.**
  2. **Failure by the creditor to adequately describe the assets of the principal debtor is within the risk of the creditor.**

c. The benefit of division *(beneficium divisionis*). Art. 1951.

i. **Benefit of division presupposes the existence of <u>several sureties</u> for the same obligation and to the same debtor. It is applicable when one of the sureties is sued for the whole or more than a pro rata share of the primary obligation.**
ii. **The surety who is proceeded against may require the creditor to divide his share of the debt. Each individual surety is a principal debtor to his share and a guarantor to the individual shares of the other co-sureties. But only in the case of insolvency of another surety may a surety be obliged to cover the share of that other surety.**
iii. **In short, the plea of benefit of division converts the liability of the co-sureties from several to pro-rata.**
iv. **Of course, even in the case of several sureties, any one of them may always avail himself of the defense of benefit of discussion.**
v. **The defense of benefit of discussion is only <u>dilatory as it simply postpones</u> the action of the creditor, whereas that of benefit of division is <u>preemptory</u> as it determines the extent of liability of the surety.**

d. **<u>Summons to proceed. Art. 1938</u>**
i. **This pertains to the right of the surety to demand the creditor to bring an action against the principal debtor where the obligation falls due.**
ii. **The time limit for so doing under the Civ. C. is six weeks following the notice reminding the creditor to proceed against the debtor.**
iii. **The surety shall be absolved of any liability arising out of his obligation if the creditor fails to do so, or if he fails to continue the proceedings with due diligence.**

iv. **The rule is meant to protect the surety against collusion between the creditor and the principal debtor or against recklessness by the creditor.**

e. **<u>Tender of payment. Art. 1939</u>**
   i. **Where the debt is due, the surety may require the creditor to accept performance and/or payment.**
   ii. **In so doing, he may likewise require the creditor to hand him over all the documents and securities that would entitle him proceed against the principal debtor.**
   iii. **Refusal by the creditor to do so may relieve the surety of any obligations to the former.**
   iv. **This is a mechanism devised to protect the surety from further damages and costs resulting from procrastination of the creditor.**

IV. <u>RELATIONS BETWEEN THE PRINCIPAL DEBTOR AND THE SURETY.</u>

a. **The <u>right to indemnification</u> by the principal debtor. Art. 1940. Normally a surety is one who pays for another and, as such, he has the right to get back what he pays from that other. Once the creditor is paid, the surety becomes the new creditor on the same debtor.**

b. **<u>Scope of indemnification.</u> The surety's rights extend to the <u>principal debt, the interest thereon and the costs</u> incurred thereto, in addition to whatever damages he has sustained on account of the debtor's failure to live up to his expectations. Arts. 1940(2)(3) and 1941.**

c. **<u>Benefit of subrogation</u> (Arts. 1944 and 1945). The surety steps into the rights of the principal**

debtor upon payment since his doing so extinguishes the contractual relationship between the creditor and the principal debtor. Another important point to take note of is the fact that the benefit may not be contracted away in advance. The benefit of subrogation here is that of legal and not conventional.

d. Creditor is also bound to hand over all securities and documents of title to the surety under pain of loss of his right against the latter.

e. Distinction between a direct (chirographic) action (Art. 1940) and the benefit of subrogation (Art. 1944) in so far as they relate to the surety's right to indemnification.
   i. The direct action only entitles the surety to claim from the principal debtor.
   ii. Subrogation, however, goes beyond that and enables the surety to realize the security interests the creditor has over movables or immovables that were employed to secure the debt. Whether or not these securities belong to the principal debtor is immaterial.

f. When there ar several principal debtors in solido, he who became a surety to them has his remedy against each of them to the tune of the entire claim.

g. Second payment. (Art. 1943). Whenever the surety makes payment to the creditor, he is required to inform the principal debtor of this fact. Failure to do so may deprive him of his right of indemnification in the event the debtor settles accounts with the creditor without any prior knowledge of this payment. But the surety may demand reimbursement from the creditor for the simple reason that one cannot be paid twice.

h. **Failure by the surety to deliberately raise <u>defenses of the principal debtor</u> may result in the loss of the surety's indemnity claim. Such are what are known as <u>traditional defenses</u> of nullity, payment and extinction of obligations. (Arts. 1942 1nd 1926/3)**

i. **Rights of surety against the principal debtor <u>before payment</u>. These are known as anticipatory recourses of the surety. (Arts. 1948 and 1928)**
   i. **Where the creditor has served notice on the debtor.**
   ii. **Where the debtor is declared bankrupt.**
   iii. **Where the obligations of the surety are likely to become more onerous on account of financial losses suffered by the principal debtor.**
   iv. **Extension of the time given to the debtor by the creditor without the agreement of the surety.**

V. <u>RELATIONS AMONG CO-SURETIES. Art. 1951</u>

a. **Co-sureties are persons who guarantee <u>the same debtor/debtors to the same debt.</u>**

b. **<u>Benefit of contribution.</u> One of several co-sureties who has paid the whole debt, despite his right to invoke the defense of benefit of division against the creditor, has the right to resort to the other co-sureties for contribution in as much as a co-debtor who has paid over and above his share of the debt to the creditor does. Such a co-debtor need not bring an action against the principal debtor before proceeding against the other co-sureties.**

c. **The fact that the suretyship is made <u>in one instrument</u> or not does not have any bearing in**

as far as the rights of the paying co-surety is concerned.

d. Unless there is an agreement to the contrary between the co-sureties, the shares of co-sureties are presumed to be equal.

e. A paying surety is duty bound to raise all defenses that would absolve the principal debtor of his liability under the contract under pain of losing his right to demand contribution from the other co-sureties in as much the same manner as he loses his right of indemnity in his relations with the principal debtor.

f. Distinction between the <u>counter-surety and the secondary surety</u>. Arts. 1949 and 1950.

i. A counter-surety covers the risk of the surety, but he does not have any legal relationship with the creditor. His responsibility is to cover the damage caused to the surety on account of failure by the principal debtor to discharge his obligations. Where both the surety and the principal debtor cannot pay, the creditor does not have any recourse with the counter-surety.

ii. A secondary surety is, however, liable to the creditor should the surety and the debtor fail to discharge their obligation. He is the last person in the line of responsibility to the debtor. First the principal debtor; then the surety, and finally the counter surety.

iii. How may a counter-surety and a secondary surety exercise their right of indemnification?

VI. <u>OTHER ISSUES IN RELATION TO SURETYSHIP</u>

a. <u>Joint surety.</u>

i. **Unless the agreement of suretyship expressly provides otherwise, suretyship under Ethiopian law is always simple. There is no presumption of solidarity between a principal debtor and a surety. Arts. 1934 and 1935.**
ii. **A joint surety, once this is established, is jointly and severally liable to the creditor. For this main reason, he can invoke neither the benefit of discussion nor that of division when he is proceeded against by the creditor.**
iii. **But when it comes to contribution, unlike co-debtors bound in solido, the ultimate responsibility of payment rests on the principal debtor. The joint debtor has all the legal backing to step into the rights of the creditor, including that of the benefit of subrogation, when he proceeds against the principal debtor.**

b. **Extinction of suretyship.**
i. **The full performance by the principal debtor of his obligations is the most important ground for extinction of suretyship. Arts. 1926(1) and 1927.**
ii. **Acceptance by the creditor immovables from the debtor liberates the surety even if the creditor is evicted afterwards.**
iii. **A suretyship may come to an end on grounds that are applicable to extinction of contractual obligations.**

LECTURE NOTES ON THE LAW OF CONTRACTS
No. 8
ON THIRD PARTIES IN RELATION TO CONTRACTS

Tilahun Teshome (Prof.)

I. THE PRINICIPLE OF RELATIVITY OF CONTRACTS.

a. **In the ordinary course events, comtracts produce rights and obligations only on those who consented to their making. See Civ. C. Arts. 1675, 1731 and 1952. The classical theory of privity of contracts has it that a person not in privity (a party) could not sue or be sued on a K. It was thus held that no one may be entitled to or be bound by a K to which he is not an original party.**

b. **For practical reasons, however, this principle is subject to quite a good number of exceptions. Economic necessities, expediency of commercial interactions and societal needs in general may make it incumbent for the law to provide leeway for circumstances that give rise for strangers to be attracted to a K. these strangers are those whom the law refers to as third parties.**

c. **With this in view, the Civil Code recognizes several incidences in which third parties may be brought to and thereby assume rights and obligations that arose under a contract in which they did not take part. The following are the most notable ones.**

II. PROMISE FOR ANOTHER. (Civ. C. Arts. 1953 – 1956)

a. **This is an age old Roman law concept whose practical application is on the decline in modern business. Most major international contract instruments do not have much to say on it. But parties may make contractual arrangements similar to these rules at their pleasure.**

b. **The Civil Code considers the problem in the following two ways:**

i. **Declaration of command, Arts. 1953 and 1954.**
ii. **Promise for third party, Arts. 1955 and 1956.**

c. **In both cases, the contracts are concluded for and on behalf of third parties. In a declaration of command, one of the parties may reveal that he will bring in some one to the contract within an agreed period of time after which that third party shall become the real contracting party and assume all the rights and obligations therein. If the other party agrees to this condition, the contract is concluded. The responsibility of the person declaring the command is to bring in the named third party to the contract within the agreed time. In that case, he will be relieved of all his obligations in the K. If he fails to do so, he will continue as though he were the real contracting party.**

d. **In promise for third party, the promisor undertakes to do or to refrain from doing an act on behalf a third party. If the third party ratifies the undertaking, the promisor is relieved of his obligations. If not, the promisor either continues in the contract as if he were its party or the contract may be cancelled subject to the promisor's liability to make damages good to the other contracting party. The promisor is considered as the agent of the third party if that third party ratifies the promise.**

III. CONTRACTS FOR THE BENEFIT OF THIRD PARTIES.

a. **Where there is an agreement in a contract that one of the parties shall perform a defined obligation to a non-contracting party designated therein, it is said that the contract is one made for the benefit of a third party.**

(Civ. C. Art. 1957) Under such a scenario, three parties are involved.

i. **The person assuming to perform the obligation, i.e. the debtor.**
ii. **The one who agrees that his part of the right shall be performed in favor of another person, i.e. the stipulator.**
iii. **The one in whose favor the obligation is to be discharged, i.e. the third party beneficiary.**

b. **Relative rights and obligations of the three parties:**
   i. **The stipulator. (Art. 1958)**
      1. **He is originally the creditor in the contract and remains so until the third party beneficiary unequivocally accepts the benefit of stipulation.**
      2. **He may subject the benefit of stipulation to the choice of the third party or deprive the latter of the same.**
      3. **He may require the debtor (promisor) to perform the K for him as long as the latter has not done so for the third party beneficiary.**
      4. **He may designate another beneficiary in place of the original one.**
      5. **He may reduce the benefit of stipulation or designate another to share the benefit of stipulation.**
      6. **But this may be qualified by a separate agreement.**
      7. **He cannot change his mind after the benefit is accepted by third party.**
   ii. **The third party beneficiary. (Arts. 1959 and 1960)**
      1. **He has the right to accept or to renounce the benefit of stipulation.**
      2. **He steps into the rights of the stipulator to the extent of the scope of right stipulated in his favor.**

3. **He may require the heirs of the stipulator to abide by the benefit of stipulation if it is to be performed upon the death of the stipulator.**

iii. **<u>The debtor.</u> (Art. 1961)**

1. **He is liable to the third party beneficiary, upon the latter's acceptance of the benefit, to the tune of the stipulation.**
2. **He may refuse to tender performance if the stipulator withdraws the benefit that was not subjected to acceptance by the beneficiary.**
3. **He may not raise defenses of personal nature which he has against the stipulator once the beneficiary accepts the stipulation. The English version of Civ. C. Art. 1961 is not correct in this sense.**
4. **He may, of course, set up personal defenses that he has against the beneficiary.**

c. **<u>Consideration and the stipulation for the benefit of third parties</u>. As consideration is a very essential element of a contract at Common law, it is not unusual to draw distinction between third party beneficiaries in a contract on the purpose with which the stipulator was motivated to confer the benefit on the third party. For this reason, beneficiaries are categorized into three – donee beneficiaries, creditor beneficiaries and incidental beneficiaries.**

i. **<u>Donee beneficiaries</u> are third parties on whom the benefit of stipulation is conferred by way of a gift.**

ii. **<u>Creditor beneficiaries</u> are those to whom the benefit is conferred by the stipulator in exchange for another performance which the latter owes to them, the intention of the stipulator being that he**

would satisfy that other claim of the third party beneficiary by so doing.

iii. If the third party beneficiary does not stand the test of either a donee beneficiary or a creditor beneficiary, he is regarded as an <u>incidental beneficiary</u>. Such a person is regarded as having acquired no right under the contract that would compel the debtor (promisor) to perform the K in his favor.

IV. <u>ASSIGNMENT OF CONTRACT RIGHTS (Arts. 1962 - 1967 and 1973 – 1975)</u>

a. In the domain of the law of obligations, an assignment involves a transfer <u>a right in personem</u> (a personal right or <u>a chose in action</u> as the concept is widely known at Common Law)) as compared to that of transfers of a right <u>in rem</u> (a real right). It is a transfer of a right to claim some property interest from another to a third person. It may, therefore, be agreed that an assignment is a manifestation of intent by a creditor to transfer his personal right against his debtor to some third party. The transfer may be partial or full.

b. <u>Personal rights</u> are rights that can be claimed or enforced by action at law rather than by taking physical control. Large number of property interest including rights in a contract, shares, negotiable instruments, intellectual property rights and interests arising out of insurance policies fall into the category of personal rights and hence are in most cases assignable.

c. Following an effective assignment, three parties interface in the exercise. The creditor assigning his right is called <u>the assignor</u>; the third party for whom the assignment is made is known as <u>the assignee</u>; while the <u>debtor</u>

remains in that status; and the assigned right is called the cede.

d. In the Ethiopian Civil Code too, a creditor has a large measure of freedom to transfer his right in a contract by way of assignment to a third person. The assignor may even assign his contract right without the consent of the debtor. See Civ. C. Art. 1962. It may be made for consideration or gratuitously.

e. The right to assign contract claims may be curtailed or reduced under either of the following by the contract, by law or by the nature of the right to be assigned. This takes us to the consideration of assignable and unassignable contract rights. Normally, however, assignment is a rule and restriction an exception.

i. Parties may agree in the contract that the right created therein is not subject to assignment. In a contract of lease or usufruct, for example, parties may agree that the lessee or the usufructuary may not assign his right to make use of the property let or the thing subject to the usufruct.

ii. The law may provide that certain class of rights is not capable of assignment. The most common ones in this regard are social security rights such as pension benefits, annuities, alimonies and maintenance claims. Under Art. 404 of the C.P.C. too, properties that are not liable to attachment upon execution of judgments are not assignable.

iii. The nature of the right may also render a right incapable of assignment. The right to claim specific performance under a K, for instance, is not assignable.

f. Warranty obligation by the assignor.

i. **The assignor owes a duty of warranty to the assignee if it is made for consideration. In this case, the provisions on Ks relating to sale of goods do apply *mutatis mutandis.* (See Civ. C. Arts, 1964, 1965, 2281 and 2283)**
ii. **Although it may be stipulated otherwise by the assignor and the assignee, the assignor's duty of warranty is limited to the existence of the right and to the solvency of the debtor.**
iii. **Where the assignment is gratuitous, the assignor does not even guarantee the existence of the right.**

g. **<u>Other effects of assignment</u>.**
   i. **Assignee has all the rights of the assignor against the debtor as he is the new creditor in the k for all practical purposes. (See Art. 1963, 1973 and 1974)**
   ii. **Assignment should not be made on terms that are more cumbersome to the debtor than what he originally assumed.**
   iii. **When there is multiplicity of assignments, debtor may discharge on a first-come-first-served basis or the basis of a chronological order. (See Art. 1967)**
   iv. **The debtor may avail himself of all defenses he has against the assignor and the assignee to oppose the claim made by the assignee.**
   v. **The debtor is likewise discharged of his duty if he has paid to the assignor after the making of the assignment before such was brought to his knowledge. (See Art. 1966)**

V. <u>SUBROGATION</u> (Arts. 1968 -1975)

a. **<u>Meaning and scope.</u> Subrogation is a mode of payment or performance of K'ual obligations by a person other than the debtor in an**

obligation. In the law of Ks, payment (performance) of the most ideal way of extinction of obligations. (See Civ. C. Arts. 1940 et seq.) But payment by a person entitled to the right of subrogation does not bring an end to the K with respect to the debtor for whom it is made.

b. A new creditor is substituted to the original one while the debtor remains in that status until he pays all the debt to the substituted debtor. Subrogation is thus a legal mechanism by which a person who has paid the debt of another is allowed to assume the rights of the creditor and claim what he paid from the debtor. The creditor is forced to relinquish his right in favor of the paying new comer.

c. Three parties come into the picture upon subrogation:
   i. The creditor who is paid called the subrogor.
   ii. The one paying the debt and replacing the creditor – the subrogee.
   iii. The debtor remains in the same position despite the payment.

d. Why pay the debts of another and get subrogated?
   i. Where the law provides.
   ii. Where there is an agreement between the subrogor and the subrogee or between the subrogee and the debtor.

e. Subrogation by the law takes place by those bound to pay for others or by those bound to pay with others.
   i. Those bound to pay for others may be sureties, insurers or mortgagees.
   ii. Those bound to pay with others may be co-heirs and co-debtors in a joint and several K.

iii. **Both classes of persons are entitled to legal subrogation. The difference is that the first class of persons are entitled to the full right that the creditor had when he was paid; while the second group can only claim for contribution from those bound. (See Civ. C. Art. 1971 *cum* Arts. 1944 and 1951 for surety; *cum* Arts. 1908 and 1909 for solidary debtors, *cum* 3083 for plegees; *cum* Art. 673 for insurance; and *cum* Arts. 1058, 1959, 1111 and 1113 for co-heirs.)**

f. **K'ual subrogation is created by the agreement between the subrogee and either of the earlier parties.**
   i. **When it is made between the subrogee and the subrogor (creditor) it is required to be express and simultaneous with payment.**
   ii. **When made between the subrogee and the debtor, it assumes a form of loan the subrogee granted to the debtor. Debtor pays the sum lent to the creditor and may cause the subrogation of the third party.**

g. **<u>Other effects of subrogation</u>.**
   i. **When partial subrogation is made it should not be detrimental to the right of the creditor and the latter has priority over the subrogee on the unpaid balance. (See Civ. C. Art. 1972)**
   ii. **Once duly subrogated, the third party enjoys full rights of the creditor. The latter is bound to relinquish all his rights under the K to the subrogee including collateral, documents of title and accessory rights. (See Art. 1973)**
h. **Similarities and differences b/n assignment and subrogation.**
   i. **Similarities**

1. **In both cases the change is that of creditors while debtors remain the same.**
2. **Original creditor is fully or partially paid.**
3. **New creditors have been substituted in place of the original one.**

ii. Differences

1. **Assignment, when made for consideration, is a sale of credit while subrogation is a mode of payment.**
2. **Assignment may be made gratuitously while subrogation cannot.**
3. **Assignment normally entails warranty on the part of the assignor while there is no talk of such in subrogation.**
4. **Assignment may be for discount while subrogation cannot.**

VI. DELEGATION OF PERFORMANCE (Arts. 1976 – 1982)

a. Delegation (the old Roman concept of *delegation*) takes place when a third party agrees to assume the obligation of a debtor under a K. Normally, the agreement of the creditor is required for such an arrangement to take place to do away with whatever uncertainties that may befall upon him as a result of a change in the debtor.

b. In assignment and subrogation, the change is in the persons of creditors while it is that of debtors in delegation.

c. Delegation must be free and consent based on the part of the delegate-debtor. He cannot be obliged to assume this responsibility against his will even if he is the debtor of the person intending to bring him into the K. (See Civ, C. Art. 1978)

d. The parties interfacing in a delegation are:

- **i. The original debtor, who is known as the delegator;**
- **ii. The third party new comer who agrees to take the obligation of the debtor, referred to as the delegate-debtor or the delegatee; and**
- **iii. The Creditor who remains in the same capacity.**

e. Unless agreed otherwise, delegation does not bring an end to the obligation of the original debtor. But he is relegated to a second degree debtor in the sense that the creditor may revert back to him where the delegate-debtor fails to fully or partially discharge the obligation that he assumed. (See Civ. C. Art. 1977)

f. This is what is known as imperfect delegation in legal scholarship. On the other hand, if the creditor agrees to fully discharge the debtor when the delegation is undertaken, he does relinquish all his rights and claims against the debtor. In such a case, the delegation is called a perfect delegation.

g. Once the delegate-debtor has accepted the delegation, though, the delegator cannot change his mind and require the former to refuse performance to the creditor or to effect the payment for him. This is primarily aimed at protecting the right of the creditor whose interest is likely to be jeopardized by such arrangement. (See Civ. C. Art. 1979)

h. The delegate-debtor may neither set up defenses that the delegator has against the creditor; nor those that he himself has against the delegator. He may only set up his own defenses against the creditor. (See Civ. C. Art. 1980)

i. **Insolvency of the delegate-debtor after a perfect delegation is in the risk of the creditor if it takes place afterwards. (See Civ. C. Art. 1981)**

j. **Third parties who have secured the debt of the original debtor by way of a personal surety or a real security are relieved of any liability under the previous arrangement where the delegation is made without their knowledge or against their express consent to the contrary. (Civ. C. Art. 1982)**

VII. TRANSFER OF RIGHTS AND OBLIGATIONS TO A THIRD PARTY

a. **When an entity, or a patrimonial interest, or an estate is transferred from one person to another, the transferee assumes all the rights and obligations inherent in the transferred interest. There are many ways in which one's property interest can be transferred to another. One may destine his entire property interest to constitute an endowment or a trust. (See Civ. C. Arts. 483 – 506 and Arts. 516 – 544); his entire property may be confiscated following a criminal conviction; it may likewise be transferred by inheritance upon his death; a person may, for consideration or gratuitously, assign an estate constituting his patrimony or a part thereof to another person; when two or more independent business organizations or associations merge, their patrimony may be transferred to the entity that replaced them; when one form of business organization is converted into another (See Comm. C. Arts. 549 – 554 for conversion and amalgamation), its rights and obligations may be transferred to the newly created entity, etc.**

b. Provisions of the Civ. C. that cover the discussion at hand do, however, pertain to only some of these consequences, (Arts. 1983 – 1985). These are issues that relate to assignment of an estate, amalgamation of undertakings and formation of partnerships.

i. According to Art. 1983, <u>he who acquires an estate</u> with all its rights and obligations shall answer claims of creditors of the former owner. An estate, in legal sense, is a term employed to denote a person' property, entitlements and obligations. It is the sum of all entitlements and assets over a designated property less all the liabilities thereon. In most cases, it applies when a business that is carried out in the form of sole proprietorship is transferred from the owner to another. Properties such as buildings and plants that generate revenues may also be subjected to this rule. In this case, third parties who did not have any legal relations with the new acquirer may be entitled to raise claims against the latter or may likewise be liable to answer his claims. To do so, however, the rights and obligations should stem from the estate so transferred.

1. **The rule holds good after the newcomer to the estate publicizes his right via the appropriate channels, normally through news papers.**
2. **The transferor is also jointly and severally liable with the transferor for a period of time to be specified by the law, two years in our case.**
3. **The liability period of the transferor runs from the date of publication in respect of mature debts and from the date of maturity in respect of other debts.**
4. **Obviously, the debts for which the transferor is jointly and severally**

liable ought to have arisen before the date of transfer.

ii. **Amalgamation. (Art. 1984) When two or more entities amalgamate, their rights and obligations are automatically transferred to the newly created entity. These enables it raise claims against debtors of the amalgamated entities. It may also be held liable to answer claims of their creditors.**

iii. **When a sole proprietorship is converted into partnership, the same consequences follow. (Art. 1985)**

VIII. HEIRS OF PARTIES TO A CONTRACT (Arts. 1986 - 1987)

a. **Contracts entail right in personnam and, as such, the rights and obligations they create are in most cases transferrable from one party to another. Upon the death of parties, therefore, their heirs and legatees may step into the contract and claim rights due to their legato or answer claims of creditors of the inheritance. Even stipulations for the benefit of a third party are claimable by his heirs if the third party dies having accepted the benefit of stipulations.**

b. **Some limitations:**

i. **The rights and obligations should be transferrable to heirs by their nature. (See Civ. C. Art. 826/2)**

ii. **Transferability of the rights and obligations ought not to have limited by prior agreement of the parties.**

iii. **Heirs should accept the inheritance.**

iv. **Liability of heirs to debts of the inheritance is protected by the rule of benefit of inventory.**

IX. CREDITORS OF PARTIES

a. **The general rule. (Art. 1988) *The property of a debtor is the security of his creditors.* Property includes all kinds of property including corporeal and incorporeal, tangibles and intangibles, and those at hand and those considered as receivables.**
    i. **Normally, this right is exercised by obtaining a court order or final judgment and attaching the debtor's property. See the rules espoused by Arts. 394 – 402 of the Civil Procedure Code on execution of judgments; and Arts. Of 154 – 159 of the same Code on temporary injunctions, i.e. attachment measures to be taken by a court at the request of a plaintiff.**
    ii. **The exceptions: Properties not liable to attachment. In the Civil Code, this exception flows from the phrase "unless the contrary was stipulated or flows from the nature of the contract" in Article 1988(1) of the Code. Normally these rules are outlined in Art. 404 of the Civ. P. C.**
    iii. **It must also be seen to it that unless the debtor property is attached following the above procedure, he cannot be prohibited from disposing of his property or making use of it in any other way. Third parties who have acquired the debtor's property are protected by the law from claims of his creditors. (Art. 1989/1) The law, in addition, protects creditors by laying down rules that pertain to: (1) secured creditors; (2) preservatory action (or the oblique action as it is referred in some literatures); (3) revocatory action (or the *actio Pauliana*) and (4) the right to attack simulated contracts.**

b. **Secured creditors: (Art. 1990)**

    i. **A security interest in the debtor's property may be created by a contract or may be**

obtained by operation of the law. Secured creditors who acquire such rights by a contract are entitled to be paid prior to ordinary creditors of the same debtor from the proceeds of the sale property on which the security interest is created. Such is the case of pledges and mortgagees in Arts. 2825 et seq. and Arts. 3041 et seq. respectively. (Refer especially to the provisions of Art. 2857 on pledge, Arts. 3059, 3076 – 3078 on mortgage and Art. 192 of the Comm. C. on business mortgage. See further Arts. 3117 – 3130 of the Civ. C. on antichresis.)

ii. **The law may also entitle third parties to acquire a security interest. Such is the case of claims of workers under labour law or those of tax collectors in public finance laws. Bankruptcy laws do also entitle creditors of the bankrupt to have priority rights. (See for example Arts. 968 -973 and 1023 of the Comm. C.)**

c. The preservatory action

i. **The right to pursue claims due to one's debtor by a creditor. Arts. 1992 – 1993.**
ii. **Claim is made from third parties who have nothing to do with the contract between the debtor and the creditor.**
iii. **Action is taken in the name of a debtor but by the creditor by showing the inaction of the debtor.**
iv. **The creditor claims from the debtor's debtor. *The oblique action.***
v. **An action that is undertaken by a court approval to prevent the impoverishment of a debtor with an effect of jeopardizing the payment of his debt.**
vi. **A last choice, though, by a creditor since he cannot avail himself of this right where the debtor is solvent enough to settle his debt.**

vii. **The nature of the right to be pursued should not be such as to require the personal qualities of the debtor's debtor.**

d. **The Revocatory Action (Arts. 1995, 1996) (See also 993 and 976 the operation of the rule in the law of successions and Art. 2467 in donations.**
   i. **The right to prevent a debtor not to unduly transfer or alienate his property interest so as to jeopardize the creditor's right to enforce his claim on that property.**
   ii. **An act of bad faith by a debtor that is detrimental to his creditor.**
   iii. **The creditor challenges acts his debtor has performed with third parties with a view to preventing him from exercising his right to claim whatever is due to him.**
   iv. **Creditor should show an act of fraud or bad faith on the part of the debtor, which in most cases is difficult to prove.**