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Liability of The State in India in Respect of Contracts: A Legal Analysis

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ABSTRACT

In the current era, government contracts have gained a lot of attention. The wealth comes from the state. In the contemporary welfare state, the government's economic activities are growing, and it is increasingly taking on the role of the distributor of several benefits. When the government in India takes on the role of a welfare state, the issue of the administration's contractual duty always elicits a feeling of majority response. The state is subject to the law and is not allowed to break it. The question that emerges in this situation is whether the person who was harmed or damaged by a state action is entitled to compensation from the state.

Keywords: Government Contract, State Liability.

I. INTRODUCTION

In India the concept of state has been defined under Article 12 of the Constitution of India which says that state includes the Government and the Parliament of India and the Government and legislature of each of the states and all local and other authorities within the territory of India and under the control of Government of India. Individual rights are affected by the Acts of the State and its officials in one way or the other. These Acts are done by the state in exercise of its power as a Sovereign as well as in other capacities in the same manner as an individual does. The state is also subject to law and it cannot violate individual rights. So the main issue that arises here is whether the individual whose rights are affected or who suffers injury by the Acts of the State is entitled to remedy from the state. So there are certain options which are available to an individual to have recourse he may proceed against the officer concerned or he may sue the government on whose behalf the officer was acting. Government contracts are the contracts to which the Central Government or the State Government is a party. This paper will emphasize upon the law relating to Government contracts and the contractual liability of state in India.

II. CONTRACTUAL LIABILITY OF THE STATE BEFORE INDEPENDENCE

Liability of the State differs in different countries as the different countries have different legal systems. The concept of liability of state for breach of contract is not new in India. This concept

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was incorporated by the Royal Charter at the time of the East India Company. It was clearly laid down in this concept that merely because East India Company exercises sovereign functions they could not be immune from being sued in its own courts. Even the Government of India Acts, 1915 and 1935 empowered the Government to enter into contract with private individuals. Government contracts have a significant place in the modern economy and it is becoming important day by day.

In *Moodalay v. E.I Co*², the liability of the Government for the breach of contract was recognized even before the commencement of this Constitution. When the East India Company was established mainly for the purpose of commercial activities in India it was said that the fact that East India Company exercised the sovereign functions it cannot be said that they could be immune from being sued in its own courts to the Company. The liability of the Government had been recognized in the number of statutes also. Thus the provisions were made in the Government of India Acts of 1833, 1858, 1915 and 1935.

In *P. & O. Steam Navigation Co. v. Secy. Of State*³, it was held by the Supreme Court that no action would lie against the state where the contract was entered into in exercise of sovereign functions of the state. The Calcutta High Court observed and followed the decision of this case in *Nobin v. Secy. Of State*⁴, where it was held by the High Court that the Government was not liable for refusing to grant a license to the plaintiff for the sale of ganja as the sale of ganja was related to sovereign function. But the *Nobin v Secy Of State*'s decision was refused on the ground that P.&O. Case was a case of torts and no question of contractual liability was involved. However the Government of India Act (1915 and 1935) empowered the Government to enter into contracts with private individuals.

III. CONTRACTUAL LIABILITY OF THE STATE AFTER INDEPENDENCE

After the Independence the Contractual liability of the Union of India and States is recognized by the Constitution of India itself. Article 298⁵ expressly provides that the executive power of the Union and of each State shall extend to the carrying on of any trade or business and the acquisition, holding and disposal of property and the making of contracts for any purpose.

Article 299(1) of the Constitution of India prescribes the mode or manner of execution of such contracts. It reads:

² [1785] 1 469 (Bro. C.C)

³ [1861] H.C.R 5 (Bom.)

⁴ [1875] 1(Cal.) 11

⁵ The Constitution of India 1950

“All contracts made in the exercise of the executive power of the Union or of a State shall be expressed to be made by the President, or by the Governor of the State, as the case may be, and all such contracts and all assurances of property made in the exercise of that power shall be executed on behalf of the President or the Governor by such persons and in such manner as he may direct or authorize.”

IV. REQUIREMENTS OF THE GOVERNMENT CONTRACT

Reading the aforesaid provision, it becomes clear that Article 299⁶ lays down the following conditions and requirements which must be fulfilled in contracts made by or with the Union or a State:

- a. The contract must be expressed to be made by the president or the Governor as the case may be;
- b. These contracts made in the exercise of the executive power are to be executed on behalf of the President/Governor as the case may be; and
- c. The execution must be by such person and in such manner as the President or the Governor of the case as the case may be, may direct or authorize.

The use of the word “executed” in proportions (2) and (3) above, indicates that the contract between the government and any person must be in writing. A mere oral agreement is not valid for the purpose of Article 299(1)⁷.

The courts have generally taken the view that Article 299(1) in the Constitution is based on public policy and for the protection of the general public. In number of cases, the Supreme Court has adopted a strict view of Article 299(1) and has held that the terms of Article 299(1) are mandatory and not directory, that these formalities cannot be waived or dispensed with. Therefore a contract not meeting the conditions stipulated in Article 299(1) becomes nullified and void. Such a contract cannot be enforced at the instance of any of the contracting parties. Neither can the government be sued and held liable for damages for breach of such a contract, nor can the government enforce such a contract against the other contracting party.

In *K.P. Chowdhary v. State of Madhya Pradesh*⁸, at the auction for forest contracts, the appellant signed the sale notice agreeing to abide by the terms of the notice. One of the terms was that if the bidder failed to complete the formalities after the acceptance of the bid, his earnest money would be forfeited, the contract re-auctioned at his risk and any deficiency occurring was to be

⁶ The Constitution of India 1950

⁷ *Ibid.*

⁸ AIR 1967 SC 203

recoverable from him as arrears of land revenue. In the meantime, a dispute arose between the bidder and the forest department regarding the marking of the trees auctioned. As the dispute was not settled to the satisfaction of the bidder, he refused to complete the contract. In this case, the admitted position was that a contract complying with Article 299(1) has never been signed. The High Court dismissed the petition as it took the view that an implied contract has arisen as a result of the appellant's accepting the conditions of auction and that such an implied contract was not hit by Article 299(1) which applied only to written contracts. On appeal, the Supreme Court reversed the High Court. The Apex Court thus ruled that there was no contract between the bidder and state government. The Court reasoned that Article 299(1) being in "mandatory terms", no implied contract could be spelled out between the government and appellant. Since then the view has come to be accepted that Article 299(1) is mandatory and that a contract not complying with formalities of Article 299(1) is no contract at all and so is unenforceable in a court of law. But then, at times, the Supreme Court has taken a somewhat relaxed view of compliance with Article 299(1). Insistence on a strict compliance with these conditions may be inequitable to private parties, and at the same time, makes government operations extremely difficult and inconvenient in practice.

V. WRITTEN CONTRACT

A contract to be valid under Article 299(1)⁹, must be in writing. The words 'expressed to be made' and 'executed' in this article clearly go to show that there must be a formal written contract executed by a duly authorized person. Consequently, if there is an oral contract, the same is not binding on the Government. This is not a mere formality but a substantial requirement of law and must be fulfilled. It, however, does not mean that there must be a formal agreement properly signed by a duly authorized officer of the Government and the second party. The words 'expressed' and 'executed' have not been literally and technically construed.

In *Chatturbhuj Vithaldas vs Moreshwar Parashram*¹⁰, Supreme Court, Bose, J. observed:

"It would, in our opinion, be disastrous to hold that the hundreds of Government officers who have daily to enter into a variety of contracts, often of a petty nature, and sometimes in an emergency, cannot contract orally or through correspondence and that every petty contract must be effected by a ponderous legal document couched in a particular form....."

In *Union of India v. A.L. Rallia Ram*¹¹, tenders were invited by the Chief Director of Purchases,

⁹ The Indian Constitution 1950

¹⁰ AIR1954 SC 236

¹¹ AIR 1963 SC 1685

Government of India. R's tender was accepted. The letter of acceptance was signed by the Director. The question before the Supreme Court was whether the provisions of Section 175(3) of the Government of India Act, 1935 (which were in parimateria with Article 299(1) of the Constitution of India) were complied with. The Court held that the Act did not expressly provide for execution of a formal contract. In absence of any specific direction by the Governor-General, prescribing the manner or mode of entering into contracts, a valid contract may result from the correspondence between the parties.

The same view was reiterated by the Supreme Court in another case *Union of India v. N.K.(P) Ltd*¹², wherein the court observed:

“It is now settled by this court that though the words ‘expressed’ and ‘executed’ in Article 299(1) might suggest that it should be by a deed or by a formal written contract, a binding contract by tender and acceptance can also come into existence if the acceptance is by a person duly authorised on this behalf by the President of India.” From the above observations, it can safely be said that the Constitution does not require any formal document to be executed on behalf of the Government and only then it would constitute a binding agreement. Any form of ‘offer and acceptance’ complying with Article 299 of the Constitution would be a valid and binding contract.

(A) Execution by person authorized by the President or the Governor:

The Constitution of India does not prescribe for any mode of authorization so the normal procedure to be considered as proper authorization which is to be followed i.e. by notification in the official capacity. The court in *Bhikraj Jaipuria v. Union of India*¹³, observed that the contracts were entered into between the Government and the plaintiff firm. However no specific authority had been conferred on the Divisional Superintendent and in furtherance of the contract the order was placed by the Divisional superintendent and foods grains were supplied to the Railways. However after some time Railway Administration refused to take the delivery of goods on ground that the proper authority here was Secretary to the Railway Board and the evidence showed that officer of the Railway Board was authorized to take delivery, transport it and distribute it. On the basis of such facts the Supreme Court on considering the evidence held that Divisional Superintendent acting under the authority could enter into contracts. Court further held that it is clear that there must be clear formal written contract and the provisions of Article 299 are mandatory and any contravention of it will make a contract null and void. The

12 (1973) 3 SCC 388

13 (1962) AIR 113 (SC)

provisions of this Article 299(1) have not been enacted for mere formality but for safeguarding the Government against the unauthorized contracts and in this case Supreme Court held that the Divisional superintendent had the implied authority to execute the contract.

In *State of Bihar v. Karam Chand Thapar*¹⁴, the plaintiff entered into a contract with the Government of Bihar for construction of an aerodrome and other works. After some work, a dispute arose with regard to payment of certain bills. It was ultimately agreed to refer the matter for arbitration. The said agreement was expressed to have been made in the name of the Governor and was signed by the Executive Engineer. After the award was made, the Government contended in civil court that the Executive Engineer was not a person authorised to enter into contract under the notification issued by the Government, and therefore, the agreement was void. On a consideration of the correspondence produced in the case, the Supreme Court held that the Executive Engineer had been 'specially authorised' by the Governor to execute the agreement for reference to arbitration.

(B) Expression in the name of President or Governor:

The last requirement is that such a contract must be expressed in the name of the President or the Governor, as the case may be. Thus, even though such a contract is made by an officer authorized by the Government in this behalf, it is still not enforceable against the Government if it is not expressed to be made on behalf of the President or the Governor.

It was held by the Supreme Court in *State of Bihar v. Abdul Maji*¹⁵, that the Government Contracts are also governed by the provisions of the Indian Contract Act, 1872 like any other contract. In addition to that Government Contracts has also to fulfill the requirements of Article 299 of the Constitution. The contractual liability of the Government will be the same as that of any other individual. Article 300 of the Constitution also points out that the extent of liability of the Union of India will be same as that of Dominion of India and the provinces under the Government of India Act, 1935.

The provisions of Article 299(1) are mandatory and not directory and they must be complied with. They are not inserted merely for the sake of form, but to protect the Government against unauthorized contracts. If, a contract is unauthorized or in excess of authority, the Government must be protected from being saddled with liability to avoid public funds being wasted. Therefore, if any of the aforesaid conditions is not complied with, the contract is not in accordance with law and the same is not enforceable by or against the Government. Formerly,

¹⁴ 1962 AIR 110

¹⁵ [1954] A.I.R 786 (S.C)-

the view taken by the Supreme Court was that in case of non-compliance with the provisions of Article 299(1), a suit could not be filed against the Government as the contract was not enforceable, but the Government could accept the liability by ratifying it. But in *Mulamchand vs State of M.P*¹⁶, the Supreme Court held that if the contract was not in accordance with the constitutional provisions, in the eye of the law, there was no contract at all and the question of ratification did not arise. Therefore, even the provisions of Section 230(3) of the Indian Contract Act, 1872 would not apply to such a contract and it could not be enforced against the government officer in his personal capacity.

(C) No Personal Liability:

Article 299(2)-it provided that Government could not be held liable under Article 299. In other words it can be said that neither the President nor the Governor shall be held personally liable in respect of the contract executed for the purpose of the Constitution or the purpose of any enactment relating to the Government of India. It also provided personal immunity to the person if he makes contract on behalf of the President or the Governor.

The provisions of Article 299(1) of the Constitution [Section 175(3) of the Government of India Act, 1935] are mandatory and if they are not complied with, the contract is not enforceable in a court of law at the instance of any of the contracting parties.

In these circumstances, with a view to protecting innocent persons, courts have applied the provisions of Section 70 of the Indian Contract Act, 1872 and held the Government liable to compensate the other contracting party on the basis of quasi-contractual liability. What Section 70 provides is that if the goods delivered are accepted or the work done is voluntarily enjoyed, then the liability to pay compensation for the enjoyment of the said goods or the acceptance of the said work arises. Thus, where a claim for compensation is made by one person against another under Section 70, it is not on the basis of any subsisting contract between the parties, but on the basis of the fact that something was done by one party for the other and the said work so done has been voluntarily accepted by the other party. Thus, Section 70 of the Contract Act prevents 'unjust enrichment.'

In *State of West Bengal v. B.k. Mondal*¹⁷, a Government officer ordered for the construction of a building for the Government office as per the rules of the Department. The Contractor completed the building. Government officer took possession and began using it. But, no payment was made. The Government argued that as the contract was not according to Art.

¹⁶ (1968) 3 SCR 214

¹⁷ AIR 1962 SC 779

299(1) it was a 'no contract'. The Supreme court held indeed that there was no contract; but, Government is made liable to pay compensation, in accordance with section 70 of the Contract Act, i.e. for 'unjust enrichment'.

In this case, the pre-conditions for the application of the provisions of the Section 70 of the Contract Act have been discussed.

- a. The first condition is that a person should lawfully do something for another person or deliver something to him.
- b. The second condition is that in doing the said thing or delivering the said thing he must not intend to act gratuitously; and
- c. the third is that the other person for whom something is done or to whom something is delivered must enjoy the benefit thereof.

When these conditions are satisfied Section 70 imposes upon the latter person, the liability to make compensation to the former in respect of or to restore, the thing so done or delivered.

In *New Marine Coal Company Pvt. Ltd. v. The Union of India*¹⁸, it had been held that Section 70 of the Contract Act would be applicable even when a Contract Act had been held void; in view of the provisions of Section 173(5) of the Govt. of India Act 1935, the contract had been declared to be void; since A had performed his part of the contract and the Govt. of India had received the benefit of the performance of the said Act, provisions of Section 70 of the Contract Act were held applicable and the Govt. of India was made to pay compensation for the benefit received by it.

In *Union of India v. M/s J. K. Gas Plant*¹⁹, The Union Government supplied steel to the plaintiff company for the manufacture of gas plant at Rampur. Since all the steel was not exhausted, the steel controller, U.P. Circle, Kanpur, directed the company to deliver it to a named association at Kanpur. For lack of transport facilities, another direction was issued to deliver the same to G. Brothers at Rampur. The company complied with this order. Since neither G. Brothers nor the Union paid the price of the returned steel, the company claimed the price from the Union. The Union of India resisted the suit on the grounds that neither the constitutional requirements as to formal contracts with it has been adhered to, nor had it received any benefit from the return transaction. It is significant to refer that the controller at Kanpur had undertaken to pay off the price of the goods delivered to G. Brothers. The Supreme Court held that G. Brothers were

¹⁸ AIR 1964 SC 152

¹⁹ A.I.R. 1980 S.C. 1330

holding the steel supplied to it on behalf of the Government of India (defendant). So the government must have taken benefit of the supply. It was, therefore, bound to pay the price of the returned steel to the plaintiff company. Thus, section 70 of the Act applies against the government when the agreement under the Constitution is void, provided the ingredients of this section have been complied with as spelt out by the Supreme Court in the case of *State of West Bengal v. B.k. Mondal*²⁰.

(D) Subject to Judicial Review:

In *Ramana Dayaram Shetty v. International Airport Authority of India and Ors*²¹ the notice was issued for inviting tenders for putting up and running a second class restaurant and two snack bars at International Airport at Bombay by the first respondent and the 4th respondent was awarded contract. However the 1st respondent set aside the requirement of 5 year's experience and proceeded with the 4th respondent. The appeal was rejected by the High Court and the issue raised was whether the state was entitled to deal with its property in any manner it liked or award a contract to any person it chose, without any constitutional limitations upon it. It was held by the court that when 1st respondent entertained tender of 4th respondent despite their inexperience, then, others were denied equality of opportunity. Thus the acceptance of tender of 4th respondent was invalid as being violative of equality clause of Constitution as also of rule of administrative law inhibiting arbitrary action.

In this case the following principles emerge:-

- i. Government does not have open and unrestricted choice in the matter of awarding contracts.
- ii. Government to exercise its discretion in conformity with some reasonable and non-discriminatory standards or principles
- iii. Government is bound by standards laid down by it.
- iv. Government can depart from these standards only when it is not arbitrary to do so and the departure is based on some valid principle which in itself is not irrational, unreasonable or discriminatory.

Since then the Supreme Court laid down propositions in respect of Government Contracts. There was a change in judicial approach and it was held in this case that government no longer enjoys absolute discretion to enter into contract with anyone it likes and now the Government

²⁰ AIR 1962 SC 779

²¹ AIR 1979 SC 1628

is a private individual and the Government is bound to follow constitutional law principles if it violates Fundamental rights and then it is subject to writ jurisdiction of the court. Any contract or award by state can be challenged if it violates fundamental rights and it is subject to writ jurisdiction under Article 32 or the High Court under Article 226 of the Constitution of India.

The judiciary is only concerned with the manner in which a decision is taken and not with the fairness of the decision. So, the grounds on which an administrative action can be put to judicial review are Irrationality, Procedural Impropriety, and Illegality. These grounds are not exhaustive and further grounds can be added for judicial review.

In the case of *Tata Cellular v. Union of India*²², the Supreme Court observed that The Government should be given the freedom to enter into a contract but this freedom should be subject to the test of reasonableness and should also be free from any arbitrariness. Thus judicial review is a powerful tool in checking arbitrary Government contracts but this power cannot be used at any time because it would amount to infringing on the rights of the Executive to enter into contracts. So, whenever the contract is arbitrary or is against the proper procedure, the power of judicial review can be used. The State cannot, therefore, act arbitrarily in entering into relationship, contractual or otherwise with a third party, but its action must conform to some standard or norm which is rational and non- discriminatory.

VI. CONCLUSION

The terms of a Government contract are the same as those of a regular contract, with the exception that one of the parties to the agreement is either the Central Government or a State Government. In addition to complying with the requirements of the Indian Contract Act of 1872, a Government contract must also adhere to the requirements of Article 299 of the Indian Constitution. A person with the necessary authority enters into an express agreement on behalf of the President or the Governor to form a government contract; none of them are held personally liable. However, contracts can be enforced against the Government and it can be held accountable. By using its authority of judicial review to make sure that there is no arbitrariness or bias against a party to the contract, the judiciary also plays a significant role in government contracts. Therefore, a Government contract is legitimate and enforceable against the State when the requirements of Article 299 are fulfilled.

²² AIR 1996 SC 11