Dispute Resolution Hotline

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IMPLYING TERMS INTO A CONTRACT? SUPREME COURT SETS CONTOURS

A bench comprising of Justices Rohintan F. Nariman and Sanjay Kishan Kaul has held that:

- A contract should be read as it reads, as per its express terms
- The concept of implied terms must come into play only when there is a strict necessity for it
- Commercial courts ought to be mindful of the contemporary technical expertise of legal drafting and must not endeavor to imply terms into a contract

INTRODUCTION

The Supreme Court ("**Court**") in *Nabha Power Limited ("**NPL**") vs Punjab State Power Corporation Limited ("**PSPCL**") & another*[1] was seized with the issue of interpreting provisions of an agreement and implying terms into the language of the impugned clauses. The Court meticulously analysed domestic and international jurisprudence on the concept of implied terms in contracts. However, while attempting to apply the said tests, the Court stated that such standardized principles should not substitute the Court's own view of the presumed understanding of the commercial terms by parties.

BRIEF FACTS

The Punjab State Electricity Board ("**PSEB**") conducted an international competitive bidding process for selection of a developer for power procurement - in order to set up a power station in Punjab. M/s. L&T Power Development Ltd. ("**L&T**") was declared the successful bidder and acquired 100 per cent shareholding in NPL. NPL then entered into a 25-year Power Purchase Agreement ("**Agreement**") with PCPCL - the successor entity of PSEB. NPL was obligated to supply coal to PSPCL. Disputes arose with regard to entitlement of NPL to certain costs not expressly covered under the Agreement. NPL filed a petition before the State Electricity Regulatory Commission. The same was dismissed. NPL's appeal before the Appellate Tribunal was also dismissed. NPL then preferred an appeal before the Supreme Court of India.

THE CONTESTED CLAUSE UNDER THE AGREEMENT

The case revolved around interpretation of the following clause in the Agreement ("**Charges Formula Clause**"):

"*1.2.3 Monthly Energy Charges*

$FCOAL_n$ is the weighted average actual cost to the Seller of purchasing, transporting and unloading the coal most recently supplied to and at the Project before the beginning of month "m"." (emphasis supplied)

CONTENTIONS

NPL

In its claim for costs under the Agreement, NPL included the cost of (a) washing coal, (b) transporting, storage and handling of coal along-with (c) certain ancillary charges such as crushing and sizing of coal. NPL therefore contended that the Charges Formula Clause included all costs incurred by NPL until transportation to the project site.

PCPCL

PSPCL contended that the term 'washing' was not an express part of the energy charges formula. PSCPL further argued that the coal to be supplied could not be 'washed' coal and that the obligation of washing fell on NPL. If the parties intended, they would have expressly stipulated payment for the 'actual' cost of coal used for generation of power.

(b) Under the PPA, there were only three distinct identifiable components of coal recognized for tariff i.e. (i) Purchase; (b) Transportation and (c) Unloading. Thus, until and unless the claims squarely fall under one of the above mentioned heads, the same cannot be included in the monthly energy charges.

JUDGMENT AND ANALYSIS

The Court held that the costs included (a) costs of washing coal and (b) costs of transportation, handling and storage of coal up to the project site. The (c) costs beyond the aforesaid three components such as crushing and sizing of coal could not be implied into the Charges Formula Clause. It arrived at this conclusion on the basis of the nature of

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the contract and interpretation in a manner that would provide business sense to the terms. The Court held that, "*In the present case, we have really only read the contract in the manner it reads. We have not really read into it any 'implied term' but from the collection of clauses, come to a conclusion as to what the contract says. The formula for energy charges, to our mind, was quite clear. We have only expounded it in accordance to its natural grammatical contour, keeping in mind the nature of the contract.*"

Conditions to be satisfied to imply terms:

The Court analyzed international and domestic jurisprudence on the concept of implied terms and concluded that the following conditions must be satisfied to imply terms into contract, namely: (1) it must be reasonable and equitable to imply terms; (2) it must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it; (3) it must be so obvious that "it goes without saying"; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract.

In carving out the above tests, the Court placed special reliance on the following landmark judgments of the English Courts by Lord Bowen and Lord McKinnon respectively:

a. *The Moorcock [1889] 14 PD 64 – propounding the 'business efficacy'* test, under which the proposed term will be implied if it is necessary to give such business efficacy to the transaction as must have intended at all events by both parties who are business men; and
b. *Shirlaw v Southern Foundries (1926) Ltd [1939] 2 KB 206* – propounding the *'officious bystander'* test, wherein prima facie, that which is left to be implied and need not be expressed is something so obvious that it goes without saying; so that, if, while the parties were making their bargain, an officious bystander were to suggest some express provision for it in their agreement, and they would exclaim, 'Oh, of course!'.

In addition to the above two key judgments, the Court also analyzed the following judgments:

c. In *Liverpool City Council vs. Irwin*[2], Lord Denning observed that courts ought to imply a term in a contract when it is reasonable and necessary. The aforesaid judgment was carried in appeal to the House of Lords[3] wherein Lord Edmund Davies clarified that the touchstone for interpreting commercial documents cannot be 'mere-reasonableness' as Lord Denning had observed, but 'necessity'.
d. Lord Hoffman, sitting on the Privy Council, in *Attorney General of Belize & ors. vs. Belize Telecom Ltd. & Anr*[4], observed that the court has no power to improve upon the instrument which it is called upon to construe, whether it be a contract, a statute or articles of association.
e. In the *Union of India vs. M/s. D.N. Revri & Co. and Ors.*[5], Justice P.N. Bhagwati, observed that the meaning of commercial contracts should be gathered by adopting a common sense approach and it must not be allowed to be thwarted by a narrow, pedantic, legalistic interpretation.
f. In *Satya Jain (Dead) Through LRs. And Ors. vs. Anis Ahmed Rushdie (Dead) Through LRs. And Ors.*[6], Justice Ranjan Gogoi elucidated the well-established principles of the classic test of business efficacy to achieve the result of consequences intended by the parties acting as prudent businessmen.

Party intent

The Court held that in employing the aforesaid principles, the exercise involved is that of ascertaining the presumed intention of the parties. Unless the Court is satisfied that the implication would necessarily have been in the minds of both parties, the court cannot imply a term which wasn't explicitly expressed by the parties.

Reasonableness and Necessity

The Court reasoned that, since the implication of a term rests on the presumed intention of the parties, it is important to satisfy the primary condition that the implication must be reasonable and equitable but that one cannot ignore the objectivity with which parties entered into the relevant provisions of an agreement. Further, on the test of necessity, the Court held that a term can only be implied only if it is found necessary in order to give business efficacy to the contract. However, such implications should be avoided if the consequences would contradict what a reasonable person would understand the contract to mean.

Relevant background of the transaction:

The Court emphasized on assessing the background of the transaction and stated that, if at all a term is to be implied, it could only be implied from the language of the instrument read in its commercial setting.

In light of the above, the Court observed that reference to 'coal' in the Charges Formula Clause as provided in the Agreement would include washed coal and all charges up to transportation to the site. The Court's ruling is encapsulated below:

Actual definition in the Agreement	PSPCL's interpretation	Court's inference
FCOALn is the weighted average actual cost to the Seller of purchasing, transporting and unloading the coal most recently supplied to and at the Project.	F^{COAL}_{n} is the weighted average actual cost to the Seller of purchasing unwashed coal, transporting washed and unloading the washed coal most recently supplied to and at the Project.	The principle of 'business efficacy' would also require the Court to read the energy charges formula in a manner as would be normally understood. The mere term 'coal', therefore, would have to mean 'washed' coal, as no other type of coal could be used in the matter at hand. A plain reading of the Charges Formula Clause would include all costs of the coal up to the point of the project site. NPL had sought to claim certain other essential costs such as the transit and handling losses, third party testing charges, liaising charges. However, the Charges Formula Clause contains only three elements of transportation, handling and storage. Thus, the appellant cannot be permitted to plead

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that any other element, other than those would also incidentally form a part of the formula.

Interestingly, in addition to the issue of 'washed' and 'unwashed' coal, the Court also ventured into interpreting the terms 'to' and 'at' - being part of the Charges Formula Clause with respect to costs of transportation, handling and storage '*to and at the project site*'. The Court held that the word 'to' obviously would have reference to transporting while the word 'at' would have relationship with unloading since it would be 'transporting to' and 'unloading at'. Any other construction will fail to make grammatical sense. Further, all the three i.e., purchasing, transporting and unloading, have a reference to "the Project." Thus, the definition of F^{COAL}_{n} is the weighted average actual cost incurred by the appellant of purchasing the coal and transporting it to the project site and thereafter unloading the coal at the project site. The Court creatively attempted to apply the concept of distributive interpretation with respect to prepositions in the instant case.

The Court recognized that contracts in the contemporary era are drafted with high technical legal expertise - by legal brains from all sides involved in the process of drafting a contract, and involving avenues to clarify doubts and negotiate the terms. The Court has urged that a contract be read as per its explicit terms and has therefore cautioned commercial courts from indulging in unnecessarily implying terms into a contract and upsetting a carefully drafted contract.

By eliminating the scope of implying terms into a contract unless strictly necessary and obvious, the Supreme Court has provided the much needed caution for commercial courts to abstain from upsetting a carefully drafted contract. This should also encourage parties to clarify their contractual intentions expressly at the outset leaving less scope for future disputes arising out of different interpretations of the contract.

– Siddharth Ratho, Kshama A. Loya & Vyapak Desai
You can direct your queries or comments to the authors

[1] Civil Appeal No.179 of 2017
[2] (1976) Q.B. 319
[3] (1976) 2 WLR 562
[4] (2009) 1 WLR 1988
[5] (1976) 4 SCC 147
[6] (2013) 8 SCC 131