

# Chapter 6

## Making a Contract

### In this chapter:

- The concept of a contract
- The importance of legally enforceable agreements
- The nature of contractual obligations
- How and when contractual obligations arise
- Limitations on contractual capacity
- The essential elements of contract formation:
  - agreement
  - intention to be bound
  - formal execution *or* exchange of consideration
- Online transactions
- The doctrine of privity of contract
- Promissory estoppel

### [6.1] Introduction

#### 6.1.1 What Is a Contract?

A contract is a *legally enforceable agreement* between two or more persons who are called the ‘parties’ to the contract. When a contract is made, the parties become legally obliged to do what they have promised. If they fail to carry out their promises, they can be brought before a court and, if the case against them is proved, they can be ordered to pay compensation for the breach of their obligations.<sup>1</sup>

It must be understood that not every agreement that is entered into is a contract. Many agreements are not legally enforceable – for example, social agreements between friends or domestic agreements between family members. Such agreements are not enforceable at law and you cannot bring an action in court for damages if they are not carried out. It is the *enforceability of agreements at law* that distinguishes contracts from these other ‘non-contractual’ agreements.

This chapter explains how contracts are created. In addition, the FPBL eStudy module *Making a contract* will help you understand and apply the legal principles and rules outlined here. You will also find a quiz on contract formation in the module ‘*Quizzes and case studies for revision*’ which you can use to test yourself when you think you have learned what you need to know.

1 A legal action brought against another person is often referred to as a ‘suit’. We say that a plaintiff can ‘sue’ a defendant on grounds of breach of contract.

### 6.1.2 What Makes a Contract Legally Enforceable?

A contract is enforceable at law because, when a contract is made, the parties become subject to legally binding 'obligations'. An obligation is a duty to give or do something. For example, if a farmer enters into a contract to sell 100 bags of potatoes to a shop-owner in exchange for \$400, both the farmer and the shop-owner become bound by legal obligations to do what they have promised. The farmer has the duty to deliver the potatoes to the shop-owner and pass ownership of the potatoes to the shop-owner, and the shop-owner has the duty to pay the agreed price to the farmer. It can be seen from this example that each of the duties owed involves a corresponding right. Thus, the shop-owner has the right to delivery and to become owner of the potatoes, and the farmer has the right to be paid the agreed price. In summary, we can say that when a contract is made, it creates legally enforceable rights and duties, which we refer to as 'obligations'. How to ascertain what promises (terms) are contained in a contract is dealt with in Chapter 7.

### 6.1.3 How Are Contractual Duties Discharged?

When contractual obligations are created, they bind the parties until the relevant duties are fulfilled, or 'discharged'. Duties are normally discharged by the parties carrying out the promises contained in their contract. In the example given in section 6.1.2, as soon as the farmer delivers the potatoes to the shop-owner and makes the shop-owner the owner, the farmer has discharged those obligations. And when the shop-owner has paid the agreed price, they have discharged that obligation. When all the obligations created by the contract have been discharged, we say that the contract itself is discharged. This aspect of contract law is explained in Chapter 8.

### 6.1.4 How Is a Contract Enforced?

If the parties fail to carry out or 'perform' their promises, either at all or in the promised way, there is a *breach of contract*. When there is a breach of contract, the legal obligations remain undischarged. These undischarged obligations provide the basis for a legal action to enforce the agreement. The party to whom an undischarged contractual obligation is owed can sue the defaulting party on grounds of breach of contract and ask for an appropriate remedy – normally an award of 'damages' to compensate for harm suffered. This aspect of contract law is dealt with in Chapter 9.

### 6.1.5 The Importance of Legally Enforceable Agreements

Because contracts are legally enforceable, people who enter into them are more likely to carry out their promises voluntarily: it is better to perform contractual duties than to be taken to court for breach of contract, which is an expensive and time-wasting process. It follows from this that contracts are a valuable tool for doing business with persons you may not know well enough to trust, and with whom you have no other relationship that might encourage them to keep their promises. In other words, contracts allow strangers to do business with each other with a significant degree of reliability.

Contracts are also important when agreements involve carrying out promises over time, such as when leasing premises or hiring employees; and when promises are to be carried out in the future, such as when goods or services are to be supplied at a later date. The parties to such contracts become legally bound from the moment the contract is first made, and these obligations guarantee that the promises will be carried out or, if there is a failure to perform, that the non-defaulting party has a right to claim damages as compensation for any harm suffered as a result of the failure.

### 6.1.6 How Are Contracts Made?

From what has been said, we can see that it is important to know exactly how a contract is made and at what precise moment an agreement becomes legally enforceable. We call this aspect of contract law ‘formation’ because it deals with the particular requirements for the creation of a valid contract.

There are several things to take into account in relation to formation of a contract. For example, it is important to understand that, in many cases, a *pre-contractual* phase or process takes place before a binding contract is made. We can call this the ‘negotiation’ phase, during which the parties exchange information and explore the possibilities to see if they can reach an agreement to which they are prepared to bind themselves. The legal consequences of what is said during negotiations vary, but in the end, the fundamental question to be decided is: Was a contract finally made and, if so, what promises does it contain?

So, what requirements must be satisfied before it is possible to say ‘we now have a contract’? If we know what the requirements are, we can match them against the known facts of the individual case and decide whether or not a contract was made. The requirements of contract formation are easy to state. First, the parties must have the power to undertake legal obligations. This is referred to as ‘capacity to contract’. Not everyone has the same capacity to bind themselves legally. But even assuming adequate capacity, contracts only come into existence when the facts of the case allow you to conclude that three essential elements are all present. In summary, these elements are:

- that the parties intended to be legally bound by their agreement;<sup>2</sup>
- that the agreement was made (executed) in a document called a ‘deed’; *or*, as an alternative, that each party gave to the other ‘something of value’ at the time the agreement was made; and
- that there was sufficient agreement between the parties on the terms of the contract.

In this chapter, each of these requirements will be explained.

### 6.1.7 Using an Objective Approach to Draw Conclusions

Before going further, it is important to note that when we consider the known facts of a particular case and ask whether or not these facts satisfy some legal requirement, we must almost always use an ‘objective’ approach rather than a ‘subjective’ one. To draw a conclusion objectively involves asking: ‘What inference would a reasonable person be able or likely to make from the observable facts of the case?’. Take, for example, the requirement of contract formation that the parties must intend to be legally bound. To decide whether or not such an intention existed in a particular case, we ask whether the objectively observable or known facts allow us reasonably to draw the conclusion (or infer) that, in the circumstances, the parties must have had such an intention. We do not concern ourselves with what the parties may have actually had in mind subjectively. This objective approach is much more reliable than a subjective approach, and for this reason, it is applied in many different circumstances. It is the key to understanding many of the cases that the courts have decided.

## [6.2] Capacity to Contract

### 6.2.1 Who Can Bind Themselves by Contract?

For a valid contract to be made, it is necessary that the parties have the capacity (the recognised power or ability) to enter into legally binding agreements and subject themselves

2 Capacity to contract is explained in section [6.2].

to obligations that are enforceable at law. Generally speaking, natural persons (human beings) and artificial persons (entities such as corporations) are capable of acquiring legal rights and obligations, but not necessarily to the same extent. For example, persons who are not yet adults have only a limited capacity to contract, and some adults may have their legal capacity restricted by a mental disability, or by the effect of intoxicating drugs, or by insolvency. The rules governing capacity to enter into a contract are explained in more detail below.

### 6.2.2 Persons with Full Power to Bind Themselves by Contract

Adult persons who are of sound mind have full capacity to enter into contracts. Section 124 of the *Corporations Act 2001* (Cth) gives corporations the same legal capacity and powers as a natural adult person. Government bodies may also have the capacity to enter into contracts.

### 6.2.3 The Contractual Capacity of Minors

Persons under the age of 18 years, legally known as ‘minors’, have only a limited power to bind themselves by contract. They can do so either to acquire ‘necessities’ or to enter into contracts that are for their benefit, such as for education. This limit on their capacity protects young persons from the dangers of entering into contracts that may disadvantage them. It should be noted that some Australian states have legislation that affects the extent to which minors may or may not be bound by various types of agreement.<sup>3</sup>

#### Scarborough v Sturzaker (1905) 1 Tas LR 117

**Contract; formation; capacity; minors**

**Facts:** Scarborough, who was under the age of 18, lived about 12 miles from the place where he worked. He travelled to and from work by bicycle. While still a minor, Scarborough purchased a new bicycle from Sturzaker, trading in his old one on part payment. The purchase of the new bicycle was only legally enforceable against Scarborough if a bicycle was a ‘necessity’.

**Issue:** Given that he already owned a bicycle, was a new bicycle a necessity?

**Decision:** In the circumstances, the new bicycle was a necessity and Scarborough was therefore bound to pay for it.

**Reason:** Because of the distance Scarborough lived from his work, a bicycle was a necessity. If what is needed is already sufficiently supplied to the minor, there will be no necessity to acquire replacement goods. While he still had his old bicycle, therefore, a new bicycle would not have been considered a necessity. However, the court held that, because Scarborough had traded in his old bicycle before the new one was delivered, he no longer had what he needed and a new bicycle was a necessity.

Note: It is obvious that the court reached this decision partly on policy grounds. To have denied the enforceability of the agreement would have left the seller in difficult circumstances.

3 See, for example, *Minors (Property and Contracts) Act 1970* (NSW), s 47; *Minors Contracts (Miscellaneous Provisions) Act 1979* (SA), s 5; *Minors Contracts Act 1988* (Tas), s 4; and *Supreme Court Act 1986* (Vic), ss 49–51.

A minor also has the capacity to be bound by a contract for employment, an apprenticeship, training or education, as long as the agreement is, on balance, for the minor's benefit. If not, the agreement will not be enforceable against the minor.

### Hamilton v Lethbridge (1912) 14 CLR 236

*Contract; formation; capacity; minors*

**Facts:** Lethbridge, who was a minor, bound himself to serve for five years as an articulated clerk for the plaintiff, a lawyer practising in Toowoomba. As part of the agreement, Lethbridge agreed that, after qualifying, he would not practise as a solicitor within 50 kilometres of Toowoomba. However, a year after qualifying, Lethbridge started practising as a solicitor in Toowoomba, claiming that, as a minor, he lacked the capacity to be legally bound by the terms of the agreement with Hamilton.

**Issue:** Was the clause restraining Lethbridge from practising in Toowoomba legally enforceable?

**Decision:** The contract, including the restraint clause, was legally binding on Lethbridge, despite the fact that he was a minor at the time of the agreement.

**Reason:** Taken overall, the contract for the articulated clerkship (a form of apprenticeship) was substantially for the benefit of Lethbridge, even though it contained clauses, such as the restraint clause, that might be regarded as prejudicial to his interests. Barton J said (at 253):

The rule is that stated by Lord Esher M.R. in *Corn v. Matthews* at p. 314: – The mere fact of some conditions in the deed being against the apprentice does not enable the Court on that ground only to say that the agreement is void. It is impossible to frame a deed, as between a master and an apprentice, in which some of the stipulations are not in favour of the one and some in favour of the other. But if we find a stipulation in the deed which is of such a kind that it makes the whole contract an unfair one, then that makes the whole contract void. The stipulation which is objected to must be so unfair that it makes the whole contract between the apprentice, or the infant and the master, an unfair one to the infant.

If a minor (or other person who lacks full capacity to contract) has received things from a supplier that the minor is not contractually bound to pay for, they may nevertheless be required to pay a reasonable amount for what they have received. Otherwise, they would be unjustifiably enriched.

#### 6.2.4 Avoidance of Certain Contracts by Minors

When a minor enters into a contract that gives them a permanent interest in property or which involves a continuing obligation, the contract can be avoided if the minor so chooses, at any time before reaching the age of 18, or within a reasonable time after turning 18 years of age. If the minor does not decide to avoid the contract within this time, they are considered to have decided to continue with it, and it becomes a permanently enforceable agreement.

#### 6.2.5 The Contractual Capacity of Mentally Disabled Persons

Mental disabilities can affect an individual's capacity to contract. In some cases, individuals are declared by a court to be permanently unable to manage their own affairs. Such

persons cannot validly enter into a binding contract. However, if a mental disability does not permanently impair the individual's understanding and awareness, they will be bound by a contract unless, at the time they entered into it, their disability prevented them from understanding what they were doing and the other person was aware (or should have been aware) of their impaired mental condition.

### 6.2.6 Other Circumstances Involving Limited Capacity to Contract

There are various other circumstances in which a person's capacity to contract may be limited or restricted. In particular, a person who is insolvent (bankrupt) has a restricted capacity to enter into contracts. A person under the influence of intoxicating drugs may also be so unaware of what they are doing that they cannot bind themselves contractually.

## [6.3] The Essential Elements of Contract Formation

As stated above, there are three essential requirements or 'elements' that must be satisfied before a valid contract comes into existence. The first is that the parties, having the capacity to contract, had the intention to be legally bound by their agreement. The second is that the agreement was either formalised in a written document called a deed or, alternatively, that it involved the exchange of 'something of value' by all the parties. Third, it is required that all the terms needed for a workable transaction were agreed with sufficient certainty. Each of these elements will now be discussed in more detail.

### 6.3.1 The First Essential Element of Formation: Intention to Be Legally Bound

#### 6.3.1(a) Inferring an intention to be legally bound

The first essential element of contract formation is the existence of an intention by the parties to create and take on legally binding obligations. This intention to be legally bound is important because it allows us to distinguish between legally enforceable agreements (contracts) and agreements that are not enforceable in the courts (non-contractual agreements). The existence of an intention to be legally bound is ascertained by having regard to the objectively knowable facts of the case and drawing the appropriate inference.

#### **Carlill v Carbolic Smoke Ball Co [1893] 1 QB 256**

*Contract; formation; intention to be legally bound*

**Facts:** During an influenza epidemic in England in 1891, the Carbolic Smoke Ball Company produced patented 'smoke balls' made from certain chemicals. The company marketed these smoke balls as an effective means of preventing influenza. In particular, the company published an advertisement in a newspaper, offering to pay a reward of £100 to anyone who purchased the smoke balls, used them according to the instructions provided, but who nevertheless caught influenza. To demonstrate the seriousness of their offer, the company deposited £1,000 in a bank account from which to pay the rewards. Carlill saw the advertisement. She bought and used a smoke ball as directed. When she nevertheless caught influenza, she claimed the £100 reward promised by the company. The company refused to pay her, denying that an enforceable contract with Carlill had been created in these circumstances.

**Issue:** Could it be inferred from the circumstances that the promise to pay the advertised reward was intended to be legally binding?

**Decision:** There were sufficient circumstances to infer that the promise was intended to be contractually binding.

**Reason:** The advertisement was unlike other advertisements. The fact that it stated that £1,000 had been deposited in a bank by the company expressly for the purpose of making the promised payments demonstrated that the promise was intended to be legally binding.

### 6.3.1(b) Agreements between family members

When close family members reach domestic agreements, it is normally inferred from the facts that these agreements are not intended to be legally binding. It should be noted that, historically at least, women were more likely than men to be dependent upon such domestic agreements. The fact that courts took the view that the agreements were not intended to be enforced as contracts reinforced the dependent status of women. While the legal reasoning underlying such cases may be correct, it is important to recognise the social consequences of the law.

#### **Balfour v Balfour [1919] 2 KB 571**

*Contract; formation; intention to be legally bound; agreements between spouses*

**Facts:** Balfour was employed in Ceylon (now Sri Lanka). He and his wife travelled to England for a visit. When it was time to return to Ceylon, Ms Balfour was unwell and her doctor advised her to remain in England and rejoin her husband only when she was better. To provide for her while she remained in England, Mr Balfour promised to pay her £30 each month until she rejoined him. However, Mr and Ms Balfour later separated and divorced. Ms Balfour brought an action against Mr Balfour to enforce the promise to pay maintenance.

**Issue:** Was an agreement of this type, made between married persons, legally enforceable?

**Decision:** The agreement was not legally enforceable because, in the circumstances, it could not be inferred that it was intended to be legally enforceable.

**Reason:** Spouses make many domestic agreements, but these agreements do not become legally enforceable, 'because the parties did not intend that they should be attended by legal consequences'. The courts would be swamped if such agreements could be sued on. Atkin LJ said (at 579):

[Such agreements] are not sued upon, not because the parties are reluctant to enforce their legal rights when the agreement is broken, but because the parties, in the inception of the arrangement, never intended that they should be sued upon.

#### **Cohen v Cohen (1929) 42 CLR 91**

*Contract; formation; intention to be legally bound; agreements between spouses*

**Facts:** Ms Cohen alleged that, before she married the defendant in 1918, he had promised to pay her £100 a year as a dress allowance. The money was to be paid

in quarterly instalments of £25. The money was paid until early 1920. In 1923, the parties separated. Ms Cohen then claimed that Mr Cohen owed her £278, being unpaid instalments of the promised dress allowance.

**Issue:** Was the promise to pay a dress allowance intended to create a legally enforceable agreement?

**Decision:** Dixon J concluded that in the circumstances it could not be inferred that legally enforceable relations were intended.

**Reason:** On an arrangement between a couple engaged to be married, Dixon J said (at 96):

But these matters only arise if the arrangement which the plaintiff made with the defendant was intended to affect or give rise to legal relations or to be attended with legal consequences (*Balfour v Balfour* [1919] 2 KB 571; *Rose & Frank Co v J R Crompton & Bros Ltd* [1923] 2 KB 261). I think it was not so intended. The parties did no more, in my view, than discuss and concur in a proposal for the regular allowance to the wife of a sum which they considered appropriate to their circumstances at the time of marriage ...

A person who wants to treat an agreement with a close family relation as legally binding will need to prove additional circumstances which indicate an intention to be legally bound.

### Merritt v Merritt [1970] 2 All ER 760

**Contract; formation; intention to be bound; agreements between spouses**

**Facts:** Mr and Ms Merritt married in 1941 and borrowed money from a bank to build a house. They lived in it over the years while jointly contributing to paying off the loan. The house was originally owned by Mr Merritt alone, but in 1966, it was put into joint ownership with Ms Merritt. Some time thereafter, Mr Merritt began an extramarital relationship with another woman and left his wife. Having separated, Mr and Ms Merritt met to discuss their financial position. Ms Merritt agreed to finish paying off the loan on the house, and in return Mr Merritt promised that when the loan was completely repaid he would transfer the house to Ms Merritt's sole ownership. He signed a letter to this effect but, when the time came, he refused to transfer the house to Ms Merritt. Ms Merritt brought a legal action to enforce it.

**Issue:** Was the promise to transfer the house to Ms Merritt intended to be a legally enforceable one, despite the parties being spouses?

**Decision:** It could be inferred from the circumstances that the agreement was intended to be legally enforceable.

**Reason:** Whether or not an agreement is intended to be legally enforceable is something that is decided objectively. The court asks what intention can reasonably be inferred from the circumstances at the time of the agreement. Lord Denning MR said (at 762):

In all these cases the court does not try to discover the intention by looking into the minds of the parties. It looks at the situation in which they were placed and asks itself: would reasonable people regard the agreement as intended to be binding?



In the present case, the court decided that when the facts of a case show that the goodwill between married persons has broken down, it can be inferred that they no longer rely on honourable understandings, and that they intend their agreements to create legal obligations.

### Wakeling v Ripley (1951) 51 SR (NSW) 183

*Contract; formation; evidence of intention to be legally bound*

**Facts:** Ripley, an elderly and wealthy man, lived in a large house in Sydney. His sister and her husband (Wakeling) lived in England. Ripley wrote to the Wakelings and invited them to leave England and live with him in Sydney. He promised that the Wakelings could live rent-free in the house and that he would leave all his property to them in his will. The Wakelings sold their home in Cambridge, Wakeling resigned his lectureship, and he and his wife moved to Sydney. After about a year, a major quarrel occurred between the Wakelings and Ripley. Ripley sold the house and changed his will to exclude the Wakelings. They sued Ripley for breach of contract.

**Issue:** Was the agreement intended to be legally binding?

**Decision:** Even though this was an agreement between family members, it could be inferred from the circumstances that it was intended to be legally enforceable.

**Reason:** The letters between the parties made it clear that the Wakelings wanted the matter to be on a clear footing and in the form of a legal bargain before they were prepared to emigrate. Street CJ said (at 187):

The consequences for the plaintiffs were so serious, in taking the step that they did, that it would seem obvious that they were anxious to get a definite assurance and a definite agreement as to the provision that was to be made for them ...

#### 6.3.1(c) Agreements between friends

The likely inference is that agreements made between friends, and agreements to provide volunteer or charitable services, are not intended to be legally binding. In such cases, the person wishing to treat the agreement as legally binding bears the onus of proving any additional circumstances from which an intention to be legally bound can be inferred.

### Teen Ranch Pty Ltd v Brown (1995) 87 IR 308

*Contract; formation; intention to be legally bound*

**Facts:** Brown volunteered to work for 'Teen Ranch', a non-profit Christian organisation. Teen Ranch agreed to provide Brown with accommodation, food and the use of the camp facilities while he worked there, but did not promise to pay him any wages. Brown was subject to the rules of the camp. While working at the camp, Brown was injured. He claimed that he had entered into a contract of employment with Teen Ranch and that he was therefore entitled to receive workers compensation for his injuries.

**Issue:** Was the agreement between Brown and Teen Ranch intended to be a legally binding contract of employment, entitling Brown to workers compensation payments?

**Decision:** The New South Wales Court of Appeal held that no contract of employment existed between the parties and Brown was not entitled to workers compensation payments.

**Reason:** In the circumstances, there was 'no positive indication' of an intention by Brown and Teen Ranch to create legally binding relations. Although he received some benefits and was expected to obey camp rules while on duty, Brown's work was purely voluntary and there was no contract of employment.

### **Ermogenous v Greek Orthodox Community of SA Inc (2002) 209 CLR 95**

*Contract; formation; intention to be legally bound; relevant factors*

**Facts:** The Greek Orthodox Community of SA, an incorporated association which organised cultural, social, sporting and religious activities for its members, invited Ermogenous, then in America, to become the head of the Greek Orthodox Church in Australia. He accepted the offer and came to Australia, where he served as archbishop for 23 years. During this time he was paid a salary by the Community. At the end of his appointment, the Community refused to pay him for the accumulated leave that Ermogenous would have been entitled to under a legally binding contract of employment. The Community argued that their agreement with Ermogenous was not intended to be legally binding.

**Issue:** Could it be inferred from the circumstances that the appointment of the archbishop was intended to be a legally binding contract of employment?

**Decision:** The agreement was intended to be legally binding and Ermogenous was entitled to payment for accumulated leave.

**Reason:** The existence of an intention to be legally bound is judged on the basis of all relevant and available facts. The notion of 'presumptions' operating against such an intention in particular types of cases can easily distract from the true task of properly evaluating the particular circumstances. An agreement with a minister of religion does not in itself mean the agreement is not intended to be legally binding if other circumstances indicate otherwise, such as when an incorporated non-religious body makes the agreement and provides monetary and economic benefits to the minister.

#### **6.3.1(d) Agreements reached in a commercial context**

When agreements are reached in a commercial context, it will usually be inferred that the parties intend to be legally bound. If a party to an agreement reached in a commercial context wishes to argue that it was not intended to be legally binding, they bear the onus of proving facts to establish this, for example, by showing that the particular agreement was intended to rely only on feelings of honour or friendship.

### **Esso Petroleum Co Ltd v Commissioners of Customs and Excise [1976] 1 All ER 117**

*Contract; formation; intention to be legally bound; commercial agreements*

**Facts:** Esso Petroleum produced a set of commemorative 'coins' as collectors' items. To promote sales of its petrol, Esso promised to give motorists a 'free' coin with every four gallons of Esso petrol purchased. The Commissioner of Customs and Excise argued