

## Electronic formation of a contract

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*This paper analyses main legal problems that are related to formation of e-contracts. Because of the different legal consequences it is highly important for parties to be aware and understand the basic phases of contract formation process. For a contract to exist, usually one party must have made an offer, and the other must have accepted it. Once acceptance takes effect, a contract will usually be binding on both parties. A variety of procedures are available for forming an electronic contract, such as e-mail, EDI etc. Therefore, we have established that an electronic communication could create a legally binding contract. Business and other contracting parties should define and articulate most of the rules that will govern electronic commerce. Internationally, UNCITRAL Model law establishes rules and norms that validate and recognize contracts formed through electronic means, sets default rules for contract formation and governance of electronic contract performance.*

### 1 Introduction

Electronic commerce enables fast interactivity and business transactions between parties all over the world. Business transactions need a set of legal rules to apply to them. In international commerce the obvious choice is contract, a legal institution that determines the content of obligations and rights by mutual consent of both parties. A contract determines a flexible, yet legally binding mechanism that follows general principles of contract law – freedom of contract.

Electronic commerce is generally defined as an individual transaction by means of electronic messaging. Though it is mainly used in doing business it is quickly finding its way in other fields of our lives. It is crucial that the e-business is conducted by electronic means and with high level of automation. Unfortunately particular phases of any transaction cannot be conducted in this way (e.g. delivery of goods). Of course there are also transactions that can be entirely conducted by electronic means (e.g. acquisition of a software). The question is whether a transaction concluded and conducted entirely by electronic means can be treated as a legally binding contract.

UNCITRAL Model Law on Electronic Commerce regulated legal framework concerning formation of e-contracts on international level back in 1996. The European Communities Directive on Electronic

Commerce followed it in 2000.<sup>1</sup> This directive determines, among other dispositions, that Member States of the European Union are bound to change their legal systems in a manner that they permit formations of contracts by electronic means.

Slovenia soon followed international initiative and in 2000 enacted Law of Electronic Commerce and Electronic Signature (Official Gazette RS, No. 57/2000, CECES).

This paper analyses main legal problems that are related to formation of contracts such as offer and acceptance, time and place where e-contract are concluded. This paper will also consider the question whether the existing legal rules are suitable or is there a necessity to establish a new set of rules. The paper does not discuss the question of electronic signature, although it is closely related to formation of contracts by electronic means.

### 2 The conclusion of e-contracts

In a general manner formation of contracts is widely covered by both municipal and international law. In Slovenia the main source for law of contract is Law on obligations (Official Gazette SFRJ, No. 29/78 - LOR). However, Slovenia has adopted the new Code of

<sup>1</sup> OJ EC L 178, p.1-16, 17.7.2000

obligations that shall enter in force on 1. January 2002, which recodifies the existing legal system of contract law. However, in international commerce the main source worldwide governing sales law is the UN Convention on International Sales of Goods (Official Gazette SFRJ – International treaties, No. 10/1984 – CISG). When dealing with the CISG it is essential to pay attention to criteria of its applicability (Article 1). If the CISG is to be applied in an international sales contract, the parties must not only have their place of business in different countries, but these countries must also be contracting States to the Convention at a given time (article 100) or, where this criterion of applicability set forth in article 1(1)(a) is not met, the rules of private international law of the forum must lead to the law of a Contracting State, as indicated in article 1(1)(b). As far as the first criterion is concerned, it makes no difference whether the contract is concluded electronically or by any other means, since the only required feature is that the countries in which the parties have their place of business are Contracting States. As far as the second criterion is concerned, the use of electronic means (as opposed to more traditional means of communication) when concluding international sales contracts becomes relevant where the rules of private international law of the forum refer, as a connecting factor, to the place of conclusion of the contract. In this case, the determination of place where the contract has been concluded may cause difficulties due to lack of specific rules on this issue. Where, however, the rules of private international law of the forum do refer to connecting factors different from the place of conclusion of the contract, as do for instance the 1980 Rome Convention on the Law Applicable to Contractual Obligations, the use of electronic means should not lead to other problems than that encountered when concluding contracts by traditionally means. Therefore, at least for that area it does not appear that electronically concluded contracts should be treated differently from contracts concluded by any other means.<sup>2</sup>

## 2.1 Methods of contract formation

A contract is formed when all parties agree on its essential terms (article 26 LOR). Contractual obligations are established, changed or finished by contracts. Here an obligation is a relation between two persons, which is a legal basis for the transaction. If there is no agreement between the parties as to the terms of the contract, no contract is concluded. The agreement is reached only when both parties assent to intention to create legally binding relation as to the terms of contract. Intention of the party must be expressed as stipulated in different legal provisions. It can be expressed orally, with conventional practice or by conduct that can without a

doubt express its existence. Expression of the intention must be without mistakes and serious (article 28 LOR).

Both parties agree on formation of contract, its type and its contents. Article 23 of the CISG states that a contract is concluded at the moment when an acceptance of an offer becomes effective in accordance with the provisions of the CISG (article 23).

Contracts can be concluded by oral or written agreement. Agreement can be implied by conduct of the parties. And with regard to e-commerce, they can be formed electronically. A variety of procedures are available for forming electronic contracts<sup>3</sup>:

1. Electronic mail (“e-mail”): By exchanging e-mail communications, the parties can create a valid contract. Offers and acceptances may be exchanged entirely by e-mail, or can be combined with paper documents, faxes, and oral negotiations.<sup>4</sup>
2. Web Site Forms: In many cases a web site operator will offer goods or services for sale, which the customer orders by completing and transmitting an order form displayed on screen. When the vendor receipts the order (that is acceptance of an offer), a contract is formed. The goods and services may be physically delivered off-line.
3. Electronic Data Interchange (“EDI”): EDI involves the direct electronic exchange of information between computers. The data is formatted using standard protocols so that it can be implemented directly by the receiving computer. EDI is often used to transmit standard purchase orders, acceptances, invoices, and other records, thus reducing paperwork and the potential for human error. These exchanges (which are sometimes made pursuant to separate EDI trading partners agreements) can create enforceable contracts.

## 3 Online Offers and Acceptances

Before parties enter into a contract, each of them usually gathers data about their perspective partners. Only then the party decides whether she’ll attempt to carry out the transaction or not. The contracting parties are now engaged in negotiations (this is not compulsory phase in the contract formation process). The parties can negotiate every details of a contract and simply end negotiations by making an offer or by termination of the negotiations.

<sup>2</sup> Legal aspects of electronic commerce, UN Commission on International Trade Law, Working Group on Electronic Commerce, 38. Session, New York, March 2001, p. 6

<sup>3</sup> See T. J. Smedinghoff, *Electronic contracts and digital signatures*, p. 2

<sup>4</sup> E-mail could be compared with regular mail. More about the issue see at acceptance.

### 3.1 Offer

In order to constitute an offer to sell or buy goods in international commerce, a proposal must meet certain minimum requirements. The offer is parties' proposal for concluding a contract addressed to the specific person (paragraph 1 article 32 LOR). Such a proposal must contain all essential terms of a contract. If not, it is considered merely as an invitation to make an offer.

According to the CISG a proposal for concluding a contract addressed to one or more specific persons constitutes an offer if it is sufficiently definite and indicates the intention of the offeror to be bound in case of acceptance. A proposal is sufficiently definite if it indicates the goods and expressly or implicitly fixes or makes provision for determining the quantity and the price (article 14). Therefore the key components of a CISG offer are specificity, definiteness and an indication to be bound.<sup>5</sup> As far as the element of specificity is concerned, it appears to make no difference what form of communication one uses. In respect of this substantive feature of the offer, there are, in other words, no more problems intrinsic to electronic forms of communication than to other forms of communication.

This is basically also true in respect of the required intention to be bound, which distinguishes an offer from an invitation to make an offer. Some kinds of transactions involve a preliminary stage in which one party invites the other to make an offer. This stage is called an invitation to treat. Like Slovenian LOR, the CISG distinguishes between an offer, which binds the offeror, and an "invitation (that others) make offers" (*invitatio ad offerendum*), which have no such binding effect.<sup>6</sup>

In most cases, an offer will be made to a specified person. However, offers can be addressed to a group of people, or even to the general public. Article 33 LOR defines so-called "general offer". General offer is a proposal made to indefinite number of persons containing all essential term of a contract (*offerta ad incertas personas*). Such a proposal is considered as an offer unless circumstances of the case or legally recognized custom dictate something else. But under paragraph 2 article 14 CISG a proposal not addressed to one or more specific persons is interpreted merely as an invitation to treat. However, one who clearly indicates an intention to be bound by such a proposal will be treated as having made an offer. Yet, the new Slovenian Code of obligations is in conformity with the CISG.

Having the system described above in mind it is possible to analyse individual legal consequences of formation of contract by e-mail or EDI. The offer is always sent to a specific person if sent by e-mail. EDI on the other hand usually means closed communication between known

parties. Such a proposal is considered (in both cases) as an offer and not as an invitation to treat.

Catalogues, advertisements, price lists etc. can also be sent per e-mail. Generally, advertisements in newspapers, radio and television, catalogues, brochures, price lists are considered as invitations to treat (paragraph 1 article 35 LOR). However, the sender of such invitation is liable for prejudice cause to offerors, if he doesn't accept the offer without substantiated reason. The same interpretation might be extended to web sites through which a prospective buyer can buy goods: advertisement on a web site should be considered as invitation to treat.<sup>7</sup>

Yet the doctrine has also elaborated an opposite opinion. Catalogues, advertisements, price lists, etc. could be considered as an offer if they contain all essential terms of a future contract. They should contain precise description of goods, price, time, place and method of performance, etc.<sup>8</sup> To avoid problems whether your message is an offer or invitation to treat it is recommended that in a case of doubt there should be a clarification stipulating that a message sent is not considered as an offer. There is also a possibility to derogate the system of an irrevocable offer (article 25 New Code of Obligations) and replace it by the mechanism mentioned above.

#### Form of an offer

Form of an offer is usually not defined. When the law determines a special form as an element for the contract's validity, an offer is valid only if it is in the same form (paragraph 1, article 38 LOR). The CISG also adopted the widely accepted principle of informality. The conventions itself does not demand any special formality when issuing an offer. Its scope of application (international sale of goods) helps to explain why the authors of the convention had chosen that regulation. As a result, exchange of e-mail messages should suffice to form a legally binding contract under the CISG.<sup>9</sup>

Furthermore besides oral and written there are also so called "real offers". These are made when a party sends another party the subject of the offering.<sup>10</sup> There is no reason why an electronic offer would have less validity as the offers mentioned above. Of course there is always a question of reliability of electronic communication and possibilities of introducing evidence in court.

<sup>7</sup> Legal... p. 13

<sup>8</sup> V. Kranjc, *Prodaja po katalogih in oglasih*, *Pravnik*, 9-10/1992, p. 408-415

<sup>9</sup> Legal ..., p. 10

<sup>10</sup> Stojan Cigoj, *Obligacijska razmerja*, ČZ Uradni list SR Slovenije, Ljubljana, 1978, commentary to article 38, p. 31

<sup>5</sup> H. Bernstein, *Understanding the CISG in Europe*, p. 33

<sup>6</sup> H. Bernstein, *Understanding...*, p. 36

### 3.2 Acceptance

Acceptance of an offer means unconditional agreement to all the terms of that offer. Typical offline acceptances include written and oral communications, as well as acceptance by conduct. Their online counterparts include acceptance by e-mail or any other form of electronic message, and by conduct such as clicking on a button or downloading contents.

We can expect that case law will allow acceptance by e-mail as a reasonable practice if all parties have the means to communicate with each other. If acceptance was made by another communication method, like a letter or fax, it should be treated as an acceptance by classic means. Acceptance does not necessarily have to be sent in the same way as the offer.<sup>11</sup>

The acceptance becomes effective when the offeree's indication of assent reaches the offeror (article 39 LOR). Therefore LOR imposes receipt theory. The acceptance becomes effective also if the offeree sends goods or pays the price or makes anything else that could be reasonably treated as an acceptance of an offer. The intention to conclude a contract can be expressed explicitly, in silence or by conduct of offeror. The CISG does not deviate from LOR when dealing with acceptance. In either case the key to a successful acceptance is offeree's indication of assent<sup>12</sup>.

### 3.3 Revocation of an offer and revocation of acceptance of an offer

LOR allows offerors to revoke their offers in case that revocation reaches an offeree before or at least the same time as the offer (paragraph 2, article 36).

According to article 15 CISG an offer, even if it is irrevocable, may be withdrawn if the withdrawal reaches the offeree before or at the same time as the offer. Article 15 concerns the offeror's right to withdraw an offer. Until a contract is concluded an offer may be revoked if the revocation reaches the offeree before he has dispatched an acceptance. However, an offer cannot be revoked: (1) if it indicates, whether by stating a fixed time for acceptance or otherwise, that it is irrevocable; or (2) if it was reasonable for the offeree to rely on the offer as being irrevocable and the offeree has acted in reliance on the offer. Unlike the right to revoke in article 16, the right to withdraw deals with offers which have never taken effect.<sup>13</sup>

Note the difference between LOR and CISG view on irrevocability of an offer. Under the CISG an offer

without explicit denotation of bounding by the offer is considered revocable. However LOR enforces the opposite assumption. The CISG makes a distinction whether acceptance date is stated in an offer.

So what happens if an offeror revokes his offer while acceptance of his offer is already waiting in his e-mail box?

It is actually a question of the revocation on time. If an offeree received revocation of an offer before or at the same time as an offer, revocation was valid (paragraph 2, article 36 LOR). If revocation was not sent on time an offer binds the offeror. Also, as denoted in the CISG, if withdrawal was valid an offer does not bind the offeror. In the presented case acceptance of an offer was already sent. According to paragraph 1 article 16 CISG an offer could not be revoked if the revocation did not reach the offeree before he has dispatched his acceptance. If the offer was irrevocable, as in the example stated above, it could not be revoked as stated in paragraph 2 article 16 CISG.

Acceptance of an offer can also be revoked if the offeror received notification of revocation before or at the same time with the statement of acceptance (paragraph 3, article 39 LOR). When withdrawing acceptance of an offer receipt theory should be used as stated also in CISG, article 22.<sup>14</sup> When an offer is made to a number of persons whose identity is unknown to the offeror as, for example an web site advertisement, it is clear that it is impossible to revoke in the usual manner that is to say by sending a letter of revocation. In such a case giving equal publicity to the revocation may terminate the power of acceptance. Normally this is accomplished by using the same medium for the revocation as was used for the offer.

Regarding revocation CECES does not interfere with law of obligations. It only explicates when a party is deemed to have received a message. Unless otherwise stipulated between the originator and the addressee, the dispatch of a data message occurs when it enters an information system outside the control of the originator or of the person who sent the data message on behalf of the originator (article 9 CECES). Unless otherwise agreed, the time of receipt of a data message is considered time when it enters designated information system (article 10 CECES).

Unless otherwise agreed, regardless the paragraph 1 article 10 CECES, the receipt of a data message is considered to occur when the data message enters the designated information system if the recipient has designated an information system for the purpose of receiving data messages or when the recipient retrieved the data message if the data message is sent to an

<sup>11</sup> S. Cigoj, *Obligacijska razmerja*, p. 31

<sup>12</sup> Bernstein, p. 40

<sup>13</sup> Bernstein, *Understanding ...*, p. 37

<sup>14</sup> An acceptance may be withdrawn if the withdrawal reaches the offeror before or at the same time as the acceptance would have become effective.

information system of the recipient that is not the designated information system.

There appears to be, however, one instance where problems may arise if electronic messages are compared to more traditional ones, such as telegrams, letters, telex, as the Convention contains one provision that makes a distinction between these forms of communications. Namely, according to article 20(1) “a period of time for acceptance fixed by the offeror in a telegram or a letter begins to run from the moment the telegram is handed in for dispatch or from the date shown on the letter or, if no such date is shown, from the date shown on the envelope. A period of time for acceptance fixed by the offeror by telephone, telex or other means of instantaneous communication, begins to run from the moment that the offer reaches the offeree.” Thus, for the purpose of deciding when the time for acceptance begins to run, a decision should be made as to whether the electronic message should be compared to a means of instantaneous communication rather than to a letter or telegram.

Paragraph 2, article 40 of LOR states that parties are present when an offer is sent by phone, teleprinter or direct radio link. In these cases parties are considered present because of their ability to express their terms without a delay. This definition is clearly not problematic in every day two-way communications (e.g. talking over a phone). E-mail is another story. It is more like a one-way communication, because offeror sends his offer to offeree that is usually not going to read it at once and consequentially responds with a delay. Considering this fact it is evident that we should deal with e-mail messages more like with a regular mail than with a phone call. EDI in contrast is without a doubt a two-way communication allowing involved information systems to instantly respond to each other's messages.

#### **Effect of a Late Acceptance**

What if the offeree sends his acceptance on time but this acceptance is delayed because of errors in transfer and reaches offeror too late (late acceptance). Acceptance was received too late and is therefore considered a new offer from offeree (article 43 LOR). Still, the contract can be concluded under the terms of the expired offer if the offeror received statement after the expiration of time for acceptance of an offer, which was sent in time and he knew or could have known that it was sent on time. In that case the contract could still be concluded despite obstruction in communication. The contract would not be concluded if the offeror notified immediately or on next workday after receipt of a statement or also before receipt of a statement but after expiration of time for acceptance of an offer, to offeree that because of this delay he is not bound by his offer (paragraph 3, article 43 LOR).

Paragraph 1 article 21 CISG also indicates an exception against paragraph 2 article 18 CISG. An acceptance is not effective if the indication of assent does not reach the

offeror within the time he has fixed or, if no time is fixed, within a reasonable time, due account being taken of the circumstances of the transaction, including the rapidity of the means of communication employed by the offeror. A late acceptance is nevertheless effective as an acceptance if without a delay the offeror orally so informs the offeree or dispatches a notice to that effect (par. 1 article 21).

Acceptance of the offer cannot be revoked after it is in effect (from the moment offeror received statement of acceptance).

### **3.4 Offers and acceptances by computers using EDI**

EDI is usually closed communication between known parties. A computer program that runs on a computer of one party can generate an offer and send it using EDI to a computer program running on another party's computer. An inventory computer program could, for example, identify low supplies and automatically generate an electronic purchase order to the vendor. Computer program automatically, in the name of its owner, makes an offer and sends it to other contracting party. The computer of other contracting party can also automatically generate the answer. This imposes the question whether this is an acceptance of the offer or merely an acknowledgement of receipt.

Partial solution to that problem is offered in the Slovenian Law of Electronic Commerce and Electronic Signature. Article 5 states whether a message originates from the sender - originator. When a message is generated by information system without human intervention it is treated as originating from the legal entity on behalf of which the information system is operating. Regarding addressee of the message this is not the case. In EDI computers usually automatically acknowledge transactions, e.g. acknowledgement of purchase order. Although usually that indicates a computer's ability to read and understand the message and cannot be always treated as a legal acceptance of an offer. Of course EDI messages could contain all obligatory information to be treated as such.

Slovenian Law of Electronic Commerce and Electronic Signature (CECES) allows contracting parties to decide whether to acknowledge receipt of the message automatically or by hand. Where originator has stated that the data message is conditional on receipt of the acknowledgement, the data message is treated as though it had never been sent, until the moment when the acknowledgement is received (article 7 CECES). Where the originator has not agreed with the addressee that the acknowledgement be given in a particular form or by a particular method, an acknowledgement may be given by any communication by the addressee, automated or otherwise or any conduct of the addressee, sufficient to indicate to the originator that the data message has been

received. Therefore acknowledgement is not treated as acceptance of an offer but only acknowledgement of receipt, as would be a notice of receipt in usual written communication.

Article 8 CECES explicitly states that acknowledgement of receipt is not also acknowledgement of received content (a letter of confirmation).

Regardless of CECES the acceptance of an offer is still enforced by LOR and should be interpreted accordingly.

The person (whether a natural or legal one) on whose behalf the information system operates is liable for any offer (message) its information system generates automatically.<sup>15</sup>

#### 4 Time of formation of a contract

LOR adopted so called receipt theory for time of formation of the contract. A contract is concluded at the moment when the offeror receives offeree's accept (paragraph 1 article 31 LOR).

Article 18, paragraph 2 CISG states that an acceptance of an offer becomes effective at the moment the indication of assent reaches the offeror. Regulation under CISG is mostly identical because article 24 defines when the declaration of acceptance reaches the offeror. Declaration of acceptance or any other indication of intention "reaches" the addressee when it is made orally to him or delivered by any other means to him personally, to his place of business or mailing address or, if he does not have a place of business or mailing address, to his habitual residence.

#### 5 Place of formation of a contract

A contract is formed at the offeror's place of business or his permanent residence in time when he made his offer (paragraph 2, article 31 LOR). CECES also adopted provisions from LOR. Unless otherwise agreed between the originator and the addressee, a data message is deemed to be dispatched at the place where the originator has its place of business, and is deemed to be received at the place where the addressee has its place of business.

Electronic transmission of messages allows recipient to obtain his messages on a large distance from his information system. That is why place of information system is of no relevance. As in law of obligation permanent residence of legal entity is crucial. Cigoj argues that place of business of a contracting party that must perform a contract should be crucial when determining a place of formation of a contract.

## 6 Conclusion

E-commerce changed the way business is done and businesses quickly adopted them. When conducting business on-line a simple message can result in a contract formation. That is why businesses should be aware of relevant contract regulations. Slovenia has no special regulations that govern e-contracts. In conformity with that businesses should use other available sources of regulations, e.g. LOR or new Code of obligations. Any business conducted over the global Internet can quickly evolve in an international contract. That is when international regulations come in play. We have illustrated this in various examples in conformity with CISG. It appears that the CISG is, in general terms, suitable not only to contracts concluded via traditional means, but also to contracts concluded electronically. The rules set forth in the Convention do appear to offer workable solutions in an electronic context as well. Some of the rules, such as those relating to the effectiveness of communications, may need to be adapted to an electronic context.

In the near future new Slovenian Code of Obligations will take effect and we can concur that within the extent of this paper it is in harmony with CISG.

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<sup>15</sup> UNCITRAL Model Law on Electronic Commerce, Guide to enactment, paragraph 35.