Guidance on Liquidated Damages in India

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Background

An amount that a contracting party offers to pay or a deposit that he agrees to forfeit if he breaches any promise, and both are technically recoverable or retainable as negotiated penalties if the violation happens, having been arrived at through a good faith attempt to estimate in advance the possible harm that will almost certainly result from the breach."

"Damages for violation by any side can be liquidated under the agreement, but only at a sum that is fair in light of the expected or real harm incurred by the breach," according to the American Law Reports annotation on liquidated damages.

In its true meaning, *"liquidated liability"* refers to a monetary settlement for an injury sustained by one party as a result of the other party's violation of the contract. Normally, the extent of the harm is defined in the contract itself as a precondition to prevent any side from breaching or violating the contract. Thus, liquidated damages are a sum of money settled by the sides to a settlement that one will pay to the other if one breaks or backs out of the deal (breaching) or if a complaint occurs as a result of the violation. The following formula should be used to measure liquidated damages:

I. The amount of a down payment or a loan.

II. The use of formula (such as 10 per cent of the contract amount).

Only where (1) the condition is either "uncertain" or "difficult to quantify" and (2) the injury is "uncertain" or "difficult to quantify" may damage be liquidated under a contract.

(2) the figure is fair, taking into account the real or anticipated damage incurred by the violation of contract, the difficulties of demonstrating the loss, and the difficulty of seeking another, appropriate remedy; and

(3) The awards are formulated in such a way that they act as damages rather than penalties. A liquidated damages provision is invalid if certain conditions are not fulfilled.

The terms "liquidated losses" and "penalty" should not be used interchangeably. In the event that one of the parties takes action against the other, a responsible Court may impose a penalty.

"An amount which a party equally intends to pay or lose in the event of a violation, but which is set not as a pre-estimation of the possible real damages but as compensation, the threat of which is intended to avoid the breach," according to the American Law Reports annotation on the penalty.

The Indian Contract Act of 1872 contains some clauses to include protection in the event of a breach or termination of a contract by either of the contracting parties.

The Rule:

The Indian Contract Act, 1872, establishes the fundamental framework of Indian contract law, as well as its compliance and numerous provisions concerning non-performance and contract violation. This research aims to highlight clauses concerning "liquidated damages" in the event of contract violation and to conduct a comparative review between India and England on the subject.

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"In some cases, the liquidated damage provisions are often only given a cursory glance at the formation of a contract."

– Carl Simms

Before learning about liquidated penalties, it's necessary to consider the ramifications of contract breaches and the damages awarded in those cases. The related existing laws are Sections 73 and 74 of the Indian *Contract Act of 1872.*

Sections 73 and 74 of the *Contract Act* contain the following provisions:

Section 73: Compensation for loss or damage caused by the breach of contract: Where a contract is breached, the party who suffers as a result of the breach is entitled to receive compensation from the party who had violated the contract for the loss or damage caused to him as a result of the breach, which naturally arose in the ordinary course of things by that breach, or which the parties knew to be like when they made the contract.

Such consideration is not to be provided for any injury or harm suffered as a result of the breach in the distant or indirect sense.

Section 74: Damages for violation of the contract if a penalty is specified. When a contract is broken, the party complaining about the breach is entitled to receive reasonable compensation from the party who broke the contract, whether or not any damage or loss is proven.

An explanation is given. Increased interest from the date of default may be considered a penalty stipulation."

Under English Common Law, parties may specify an amount to be paid in the event of a default, which is irrecoverable if classified as a penalty by the Court, but recoverable if classified as liquidated damages by the Court.

The Law of Contracts in India, on the other hand, does not consider any qualitative differences in the form of damages, as section 74 abolishes the somewhat complicated refinement that existed under Common Law. Damages would be measured in the ordinary manner where there is a punitive provision, and the applicant will be able to recover a sum higher than the stipulated amount. The Court must consider the terms and underlying conditions at the time the contract was made, not at the time the violation happened, in determining the true essence of the contract and the amount of money due. The parties' words are not conclusive, and the Court is not bound by their language. The word would be viewed as liquidated losses if it is claimed to be a penalty but turned out to be a real pre-estimate of loss.

Supreme Court Decisions:

The Hon'ble Supreme Court of India has elaborated on the phrase "liquidated damages" on many occasions.

I. The Hon'ble Supreme Court of India claimed in *Fateh Chand v Balkishan Das [reported in (1964) 1 SCR 515]:*

   Section 74 establishes the legislation on the responsibility for violation of contract where restitution is predetermined by consent of the parties or where punishment is stipulated. However, the statute's scope is not limited to situations in which the aggrieved party seeks redress as a plaintiff. No party receives a special advantage as a result of this section. It simply states that, instead of any term in the contract specifying damages or allowing for forfeiture of property as a punishment, the Court can only grant fair relief to the aggrieved party not exceeding the amount named or penalty stipulated.

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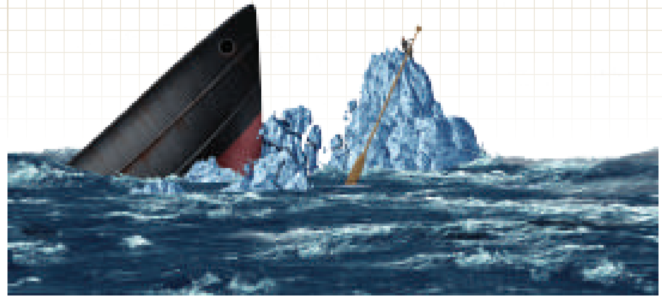
"Every breach you look at occurred because somebody inside did something they weren't supposed to do. Sometimes there's an accomplice, but most of the time, it's innocent."

– Frank Abagnale



The object of such clauses, particularly in commercial contracts, is to foster certainty. Parties to a contract will set such a number in advance at the time of contracting because it makes it easier to calculate costs, decreases the complexity and cost of proving real injury or failure, and makes it easier to recover losses. It also prevents the challenge of assessing damages, particularly through the effects of the breach is known and the risk of under-compensation; otherwise, the law of remoteness can prevent the party from recovering indirect, substantive damages. It assures the promisee that the promise will be fulfilled in a secure manner.

II. In the case of *Saw Pipes [reported in (2003) 5 SCC 705],* the Supreme Court established the following rules for determining "fair compensation" under section 74 of the *Contract Act:*

Before determining if an applicant is entitled to arbitration, the provisions of the contract must be considered; if those terms are unambiguous, the sum specified therein must be paid unless it is determined to be a penalty or otherwise unfair. Section 74 is to be read in conjunction with section 73 in all cases of violation because it is not necessary for a claimant to prove real losses before claiming a decree; a court has the authority to grant "fair compensation" in cases of breach regardless of the nature of such evidence. When it is difficult for the Court to ascertain damages with precision, the Court can safely award the stipulated amount if it is the plaintiffs' true pre-estimate of damages as a measure of fair compensation.

III. In *Chunilal V. Mehta & Sons Ltd. v. Century Spg. & Mfg Co. Ltd. [AIR 1962 SC 1314],* it was held that "by arranging for restitution in express words, the right to demand damages under the common law is generally excluded."

Applications:

In all contracts, "liquidated losses" can be used as a precaution. Proper drafting of this term in the contract will lead to protracted lawsuits, resulting in unnecessary expenditures by the contracting parties as well as squandering the justice system's valuable time.

In the case of a delay, it is standard practice to provide a clause for the deduction of liquidated losses in key contracts. The aim of such provisions is to predetermine the amount owed as damages between the parties in the event of a delay in completion.

Subcontracts, on the other hand, seldom provide liquidated losses in the case of a subcontractor's delay.

The main explanation for this is self-evident. A contractor can easily calculate the number of costs that would be incurred if the project is delayed in its entirety. The main contractor, on the other hand, cannot easily predict the loss it will incur as a result of a subcontractor's delay since the loss will come from a number of sources depending on the type, conditions, and timing of the delay. Damages levied by the employer, related expenses incurred in supplying its own extra services, and lawsuits by other subcontractors and vendors which all be included in the main contractor's losses.

The courts have been willing to interfere with enacting liquidated damages laws, recognizing that those provisions favor all sides.

"There is an excuse why parties to construction contracts should commit to liquidated penalties for non-completion," the judge said in Temlock v Errill in 1987. Proof of a failure is always impossible to obtain, and a pre-arrangement saves time and money in the event of a dispute."

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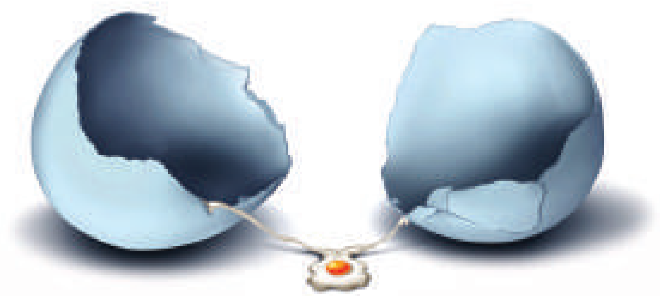

"We regard an action of Contract as an action to prevent or compensate for a breach of a promise; an action of Tort as an action to punish or compensate for a wrong, to such as assault or defamation, which has not any necessary connection with a promise. "

- Edward Jenks

The courts would not apply the liquidated liability clause where the amount stipulated is found to be a penalty rather than a true pre estimation of the loss, which has long been recognized in the industry.

The idea of requiring settlements to be made in the form of restitution rather than fines dates back to the Equity courts, where it was intended to prevent people from making unconscionable deals or overstepping their bounds. The distinction between a fair liquidated liability provision and an invalid penalty clause is discussed in today's Section 2 718(1) of the Uniform Commercial Code.

Rather than approaching a Co, parties entering into a contract should take precautions to include the relevant Clause containing the applicable laws (i.e. Sections 73 and 74 of the *Indian Contract Act 1872*) by properly indicating liquidate damages in the event of breach/violation of the contract by either side, to ensure smooth conduct of the terms and conditions as contained in the agreement

Extra benefits:

Liquidated damages provisions include a number of financial benefits. First, they have cost predictability, allowing parties to weigh the cost of expected success against the cost of a breach. Liquidated losses act as a form of minimal protection on all parties in this way. Another benefit of liquidated damages provision is that they enable the parties to agree on a settlement amount rather than leave it up to the courts, which will incur more costs in terms of time and legal expenses.

The big picture:

If the stipulated amount increases the real injury, the courts of the United States appear not to apply the Liquidated Damages provisions, believing that in the case of a violation of contract, justice demands nothing more than restitution for the amount of the hurt sustained...

As a result, courts have imposed restrictions on contract rights.

Since determining the foreseeability of the "genuine pre-estimation of loss," courts in England and Australia are more likely to uphold contract freedom and impose contract terms regardless of real loss.

If the Liquidated Damages provisions are found to be invalid as a punishment, the Employer can sue for substantive damages, which may surpass the amount specified in the Liquidated Damages provision. Famous Delay Cases include the following:

Below are some examples of cases where the legal position on liquidated damages has shifted under various rules.

The Case of Galoo (UK)

The rules that are underlying the grant of liquidated damages as considered by the Court of Appeal in *Galoo v. Bright Graham Murray [1995],* where the question in the Galoo case was whether a firm of accountants and auditors was responsible for trading losses suffered by a corporation which continued to trade during the firm's negligent audit work.

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"Damages are designed not only as a satisfaction to the injured person, but likewise as a punishment to the guilty, to deter from any such proceeding for the future, and as a proof of the detestation of the jury to the action itself."

- Lord Mansfield, Case of John Wilkes (1764)

Without a doubt, it must be shown that if the firm had done its job correctly, it would have stopped selling and saved the resulting trading losses. The concern was whether there was sufficient evidence of a causal connection between the breach of contract (i.e., the reckless audit) and the loss claimed. It wasn't, according to the Court of Appeal.

...if a Defendant's breach of contract is to be held as an "effective" or "dominant" cause of the Plaintiff's loss, it must first be held to be an "effective" or "dominant" cause of his loss. It's important to differentiate between a breach of contract that results in a loss for the Plaintiff and one that simply allows him to absorb the loss.

Despite the fact that the situation was not actually related to a construction dispute, it raised the issue of the validity of one party to a deal defaulting on the other party's default.

The Case of St. Jones College (Australia)

It's worth remembering the case of St. Jones College, where the Australian contractor was unable to be released from his original obligation to finish the works on schedule, despite the fact that the delay was not due to his negligence.

The Case of Utley James (US)

The Court in the United States, in the case of Utley James, did not hold the contractor liable for delays that did not impact the crucial route.

Summary

I. Contractual terms must be considered when determining if the party seeking damages is entitled to compensation.

II. Where the terms of the contract are explicit and unambiguous, stipulating liquidated damages in the event of contract violation until it is determined that such an estimate of damages/compensation is unreasonable.

Section 73 of the *Contract Act* requires the party that has caused the violation to pay that money, whether it is unfair or by means of punishment.

III. Since Section 74 is to be read in conjunction with Section 73, the party aggrieved by the violation is not allowed to show any injury or harm until claiming a decree in any case of breach of contract. And if no real injury is proven as a result of a contract violation, the Court has the authority to pay fair penalties.

IV. Under such contracts, it would be difficult for the Court to determine the pay-out due to violation, but if the compensation is not a liability or unfair, the Court will grant it if it is a genuine pre-estimate by the parties as to the calculation of fair compensation.

"Nominal damages are in effect, only a peg to hang costs on."

- William Henry Maule, J., Beaumont v. Greathead (1846)

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