

**Whether incorporating a clause for liquidated damages in a contract is Advantageous or Disadvantageous to the parties to the contract?**

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Every one enters a commercial contract for a financial benefit and both the parties have obligations to perform a contract. When one party performs its obligations and the other has not performed, the party which performed or willing to perform, gets injured by the act or omission of the other party. The Origin of law relating to contract damages is the endeavour of lawmakers to compensate an injured person for a breach committed by the other party to the contract. Hence the analysis about law of contract damages start from the breach of a contract by one or more of the parties to a contract. The breach of contract can be due to non-fulfilment of the obligations, delay in fulfilling the obligations or abandonment or termination etc. But the issue of damages arises from the breach of a contract by a party to a contract. The breach may take any of the following three forms namely

- a) Where a party fails to perform his obligation upon the date fixed for performance.
- b) A breach may arise from express repudiation i.e. Where a party states expressly that he will not perform his promise.
- c) There is a breach if a party does some act which disables him from performing his obligations. If these forms of breaches, the second and third may occur before the performance is due.<sup>2</sup>

Hence it can be understood that the contract damages may occur even before the starting of the execution of the contract.

India being a common-law country, our legal Principle about damages is influenced by the concept of unjust enrichment. Hence damages are directly connected to the actual injury and losses incurred by a party due to the breach of contract. Breach of contract is constituted by breach of express terms of agreement and not of a possible intention of parties. Hence the duty of the arbitrators or the court, while handling such a contract damage matter, is to ascertain the correct loss of the injured party and compensate the injured party by an adequate damage amount. Even though the concept of damages look like a deterrent to stop parties to the contract from breaching the contract, in fact it is not true. There is always a consistent judicial view to applying reasonableness to the amount of damages. Hence the courts in India have never recognised damages which are excessive and punitive in nature. From the above it can be understood that the damages are not for earning profit in distress but for compensating the loss of a party which underwent a loss due to the breach of contract of the other.

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<sup>2</sup> LAW OF CONTRACT BY CHESHIRE AND FIFOOT (1964 Edition Page 501)

The Endeavour of the author is to deal with the advantages and disadvantages in having a clause for Liquidated damages in a contract, in the light of the legal provisions and the development of law through various court judgments. The concept of damages is directly relatable to the losses or injury suffered by one party due to breach of the other party. The concept of Liquidated damages is directly relatable to the “Pre-estimated loss” of a party in case of a specific breach of a contract. It is not necessary that the liquidated damages replace the entire scope of granting of regular damages in a contractual matter. In most of the cases the possibility for damages and Liquidated damages exist together because all kinds of damages need not be covered in a clause for liquidated damages. This is mainly because the Pre-estimate of damages are not possible, for each and every injury arising out of a contract. It is important to note that the courts do not recognise a Liquidated Damage amount as it is, if it is excessive in the eye of a common man and hence liquidated damages have also to be reasonable.

Ascertained and liquidated damages are those freed from obscurity and determined by agreement, or it may be by the Court, to indicate a precise amount of in-datedness or damage or precise data from which the sterling value can be obtained: is being remembered that the contract covenants must be construed as a whole and not in compartments. Thus, the sum be reasonable, not excessive and not inadequate.

Under the common law a genuine pre-estimate of damages by mutual agreement is regarded as a stipulation naming liquidated damages and binding between the parties; a stipulation in contract in *terrorem* is a penalty and the court refuses to enforce it, awarding to the aggrieved party only reasonable compensation. The Indian Legislature has sought to cut across the web of rules and presumptions under the English common law, by enacting a uniform principle applicable to all stipulations naming amounts to be paid in case of breach, and stipulation by way of penalty.

When contract has been broken, the party who suffers by such breach is entitled to receive compensation for any loss which naturally arises in the usual course of thing from such breach. If the parties knew when they made the contract that particular loss is likely to result from such breach, they can agree for payment of such compensation. In such a case, there may not be any necessary of leading evidence for proving damages unless the court arrives at the decision that not loss is likely to occur for such beach. Further, in case where the court arrives at the conclusion that the terms contemplating damages is by way of penalty, the Court may grant reasonable compensation not exceeding the amount so named in the contract on proof of damages. However, damages are required to be proved by sufficient evidence when the agreement does not provide for genuine pre-estimated liquidated damages. The stipulated liquidated damages must not be in the nature penalty, where there is a clear finding by the arbitral tribunal that the breach of contract did not result in any loss or legal injury, a compensation would not be payable.

#### **Expectations of the parties and Legal Position about Liquidated damages: -**

Every contracting party, particularly the owner or the main contractor, while contracting or subcontracting a work to a contractor or a subcontractor, believes that by specifying a specific



amount as Liquidated damages for a breach they are entitled and eligible for that amount by way of damages, in case of the failure of the other party to perform. The above said general understanding seems to be far from the truth in view of the court decisions, on this subject. In our country, even though law is laid down by the legislature, the supreme court of India fine tunes it by way of its judgements. The specific provisions of laws S.73 and S.74 of the Contract Act which deal with the Damages and Liquidated damages are reproduced below for the convenience:

**73. Compensation for loss or damage caused by breach of contract** – *When a contract has been broken, the party who suffers by such breach is entitled to receive, from the party who has broken the contract, compensation for any loss of damage caused to him thereby, which naturally arose in the usual course of things from such breach, or which the parties knew, when they made the contract to be likely to result from the breach of it.*

*Such compensation is not to be given for any remote and indirect loss or damage sustained by reason of the breach.*

**Compensation for failure to discharge obligation resembling those created by contract** – *When an obligation resembling those created by contract has been incurred and has not been discharged, any person injured by the failure to discharge it is entitled to receive the same compensation from the party in default, as if such person had contracted to discharge it and had broken his contract.*

*Explanation – In estimating the loss or damages arising from a breach of contract, the means which existed of remedying the inconvenience caused by the non-performance of the contract must be taken into account.*

**74. Compensation for breach of contract where penalty stipulated for** – *When a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be the penalty stipulated for.*

*Explanation – A stipulation for increased interest from the date of default may be stipulation by way of penalty.*

*Exception – when any person enters into any bail bond, recognizance or other instrument of the same nature or, under the provision of any law, or under the order of the (Central Government) or of nay (State Government) gives any bond for the performance of any public duty or act in which the public are interested he shall be liable upon breach of the condition of any such instrument, to pay the whole sum mentioned therein.*

*Explanation – A Person who enters into a contract with Government does not necessarily thereby undertake any public duty, or promise to do an act in which the public are interested.*

The endeavour of the author is to deal with the above said S.74 of the Indian Contract Act, in the light of the important judgements which fine-tuned the law relating to the liquidated damages. The following are the important judgements of the supreme court of India, which developed the law relating to Liquidated damages:

1. **Fatech Chand Vs Balkishan Das<sup>3</sup>** : This is a five-judge bench judgement of the Supreme Court of India which dealt with S.74 of the Indian Contract Act and held that in all cases where there is a stipulation, in the nature of penalty for forfeiture of an amount, deposited pursuant to the terms of the contract which expressly provides for forfeiture, the duty of the court is to award such sum which is considered to be reasonable but not exceeding the amount specified in the contract as liable to forfeiture. Hence this judgment made it clear that even though the liquidated damage amount is specified in the contract, it need not be straight away given to the other party and court must determine the reasonable compensation but not exceeding the amount specified in the clause. Hence the amount specified in the liquidated damage clause is upper limit and no party can claim more damage than the amount specified in the contract. Hence the power of the court to determine the reasonable amount is retained by the court and it is not taken away by the clause.
2. **Maula Bux Vs Union of India<sup>4</sup> 1969(2) SCC 554**: This is a three judges bench judgment which again dealt with S.74 in the light of various judgment including Fateh Chand, Kunwar Chiranjit Singh<sup>5</sup>, Natesa Iyer<sup>6</sup> etc., It held that *“it is true that in every case of breach of contract the person aggrieved by the breach is not required to prove actual loss or damage suffered by him before he can claim a decree and the court is competent to award reasonable compensation in case of breach even if no actual damage is proved to have been suffered in consequence of the breach of contract. But the expression” Whether or not the actual damage or loss is proved to have been caused there by” is intended to cover different classes of contracts which come before the courts. In case of breach of some contracts it may be impossible for the courts to assess compensation arising from breach, while in other cases compensation can be calculated in accordance with established Rules. Where the court is unable to assess the compensation, the sum named by the parties if it be regarded as a genuine estimate may be taken into consideration as the measure of reasonable compensation but not if the sum named is in the nature of penalty. Where loss in terms of money can be determined, the party claiming compensation must prove the loss suffered by him. In the present case, the Government could have proved the rates at which they had to*

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<sup>3</sup> Fatech Chand Vs Balkishan Das (1964)1SCR515

<sup>4</sup> Maula Bux Vs Union of India 1969(2) SCC 554:

<sup>5</sup> Kunwar Chiranjit Singh Vs Har Swarup AIR 1926 PC 1

<sup>6</sup> Natesa Iyer Vs Appavu Padayachi ILR37Mad178

*be purchased and also other incidental charge incurred by them in procuring the goods contracted for. But no such attempt was made”.*

In the above judgment, the Supreme Court further increased the burden on the injured party to prove the actual monetary loss when the loss can be calculated in terms of money. It also further stated that in cases where the damages or loss cannot be assessed, the sum mentioned in the contract, if reasonable can be accepted and if it is a penalty, a reasonable amount can be determined not exceeding the amount mentioned in the contract. Hence the liquidated damage clause in a contract does not take away the burden of the injured person to demonstrate the actual loss, in cases where the injury can be calculated in terms of money.

3. **Oil and Natural Gas Commission Vs SAW Pipes<sup>7</sup> AIR 2003 SC 2629:** In this Judgment Supreme Court of India gave relief to the injured party by holding that if the LD amount mentioned in the contract is unreasonable or excessive, the party breached the contract should prove it. It further held that “In certain contracts, it is impossible to assess the damages or prove the same Such situation is taken care by Sections 73 and 74 of the Contract Act and in the present case by specific terms of the contract. When the terms of the contract are clear and unambiguous then its meaning is to be gathered only from the words used therein”. “Where in respect of situations where it would be difficult to prove exact loss or damage which parties suffer because of breach thereof, if parties have estimated such loss after clear understanding, it would be totally unjustified to arrive at the conclusion that the party who committed the breach of contract is not liable to pay compensation”. In this judgment, the Supreme Court clarified a situation where the damage or loss is not in the nature of clear assessment. But since most of the claims falls in the category where the assessment of actual loss is possible, which requires the injured party to prove the quantum.
4. **Kailash Nath Associates Vs Delhi Development authority<sup>8</sup> (2015) 4SCC 136:** This is a very rare case in which DDA got profit while reauctioning the property, on the failure of Kailash Nath Associates to make the auction amount within the stipulated time. In this judgment, Supreme Court made it clear that the compensation by way of even liquidated damages is permissible only in cases where there is a loss to the injured person. Hence again the burden of pleading and proving loss becomes a pre-condition to claim damages.
5. **M/S. Hind Construction Contractor Vs State of Maharashtra<sup>9</sup> (1979) 2SCC 70:** In this case, Supreme Court of India dealt with the concepts of “time is the essence of the

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<sup>7</sup> Oil and Natural Gas Commission Vs SAW Pipes AIR 2003 SC 2629

<sup>8</sup> Kailash Nath Associates Vs Delhi Development authority (2015) 4SCC 136

<sup>9</sup> M/S. Hind Construction Contractor Vs State of Maharashtra (1979) 2SCC 70:

contract” and “Liquidated damages. If contract terms provide for some clauses which provide for extension and proportionate damages for delay of a day or a week, then the contract was held to be a contract in which time is not the essence of the contract. As a consequence, the delay related LD clause will get nullified. But unfortunately, even today each and every contract has such clauses and hence if they end up in a judicial proceeding, they will have no value. As per the above judgment the only cure to make such a contract in which time is the essence, is to issue a fresh notice fixing a new deadline. In most of the cases it does not happen.

**Conclusion:** Hence from the above-mentioned discussions we can understand that the incorporating a liquidated damage clause in a contract helps the injured party only to the very limited extent of protecting the right to claim damages as per the LD clause, where the LD prescribed in the clause is reasonable in the eye of an arbitrator/ court and when the loss incurred is not measurable in terms of money. All other cases with LD clauses are treated at par with cases without LD with an added disadvantage of upper limit for claiming damages.

More over if a LD clause is not properly drafted as per law, keeping the concept of “Time is the essence” the delay related LD provision has no value in the eye of law, unless a fresh notice with a new deadline to complete is issued. Hence the provision of a LD clause in a contract without proper drafting and without evaluating the nature of expected claims will put the parties into a more disadvantageous situation, than not incorporating a Liquidated damages clause in a contract.