The Origins of Liquidated Damages in the Indian Jurisprudence

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As students of law all of us at some point are introduced to the concepts of 'Penalties' and 'Liquidated Damages' ("LD") which form a crucial part of contractual agreements. Needless to say, these terms have a very firm and well evolved jurisprudential underpinning to them. In present times, we have simultaneously witnessed the increasing complexity of contractual agreements encompassing billion dollar deals and the evolution of jurisprudence of the above-mentioned concepts. With reference to the latter, we often come across enquires as to the difference between Penalties and LD's, or what is the statutory requirement to prove actual loss under the relevant provisions of the Indian Contract Act, 1872 ("Contract Act") or on whom lies the burden of proof in a LD clause. Hence, it would be pertinent to revisit our understanding of the very nature of these contractual clauses and study how the concepts have evolved over time.

In what unfolds as follows, this article endeavors to *firstly*, trace the earliest judgments of the English courts which lay down the foundational understanding of the concept of LDs', and *secondly*, make an analysis of a few landmark judgments given by the Supreme Court of India ("SC") on this specific topic, namely the cases: **[i]** Fateh Chand v. Balkishan Das ("Balkishan Das"), **[ii]** Maula Bux v. Union of India ("Maula Bux"), **[iii]** Oil & Natural Gas Corporation Ltd v. Saw Pipes Limited ("Saw Pipes") and **[iv]** Kailash Nath Associates v. Delhi Development Authority ("Kailash Nath"). In conclusion, we shall highlight certain issues with the latest *Kailash Nath* decision.

English cases and foundational jurisprudence:

Contractual agreements, at times, have a clause stating that in case one of the parties fail to perform or adhere to a particular contractual obligation, such party shall be liable to pay either a specific or an ascertainable amount of money. It would be upon the adjudicating authority to interpret the clause and decide if it is in the nature of a LD or a penalty. The difference between the two concepts is crucial. The principal difference lies in the fact that while an agreement to pay a penalty for breaching a contract is unenforceable, LDs' can be recovered irrespective of the actual loss suffered by the party.

The jurisprudential difference between Penalties and LD's was explained very succinctly in an early case known as *Law* v. *Redditch Local Board* [1] where it was held that the distinction between penalties and liquidated damages depends on the intention of the parties to be gathered from the whole of the contract. In a scenario, where the parties would have intended to secure performance of the contractual agreement by imposing a fine, then the sum specified must be understood be a penalty, but on the other hand, in case the intention of the parties is to assess the damages for breach of contract, it must be deemed to be in the form of LDs'.

On this note it would be pertinent to observe that mere usage of the terms 'penalty' and/or 'liquidated damages' by the parties in the contractual document is not of any crucial importance and therefore, inconclusive in itself. The English Courts, as a matter of judicial practice, would enquire and make an attempt to ascertain whether or not the concerned litigants had genuinely attempted to assess the damages. This judicial dictum was echoed by the Court in the case of *Clydebank Engineering and Shipbuilding Co.* v. *Don Jose Ramos Yzquierdo Y Castaneda*.[2]

The English Courts had also developed and laid down a detailed guiding jurisprudence on how to determine if a stipulated monetary sum is to be understood as LD's or a Penalty. In this regard, attention is invited to the opinion of Lord Dunedin in the popular case of *Dunlop Pneumatic Tyre Co., Ltd.* v. *New Garage and Motor Co., Ltd.*,[3] wherein His Lordship proposed a few rules for such determination as mentioned above: *Firstly*, an amount must be deemed to be a 'penalty' if it is extravagant and unconscionable in comparison with the greatest possible loss that could have conceivably been proven to have followed from the contractual breach. *Secondly*, 'penalty' should be read into the understanding of the 'sum stipulated' in situations where the breach consists only in not paying a sum of money wherein such stipulated sum is greater than the sum which ought to have been paid. *Thirdly*, the Courts will presume a sum to be a penalty wherein a single lump sum amount is made payable by way of compensation on the occurrence of one or more events, some of which may occasion serious damage while others will be trifling. *Fourthly*, the fact that consequences of a contractual breach would render a pre-estimation impossible, does not in any way, affect the sum stipulated being a genuine pre-estimate of potential damage. In fact, it is precisely the situation when it is probable that the pre-estimated damage was the true bargain between the concerned parties.

It is thus crucial to note, as was held in the case of *Wallis* v. *Smith*,[4] that when a sum is stipulated as providing for LDs' it is payable in full whether the damage suffered by the aggrieved party is greater or lesser, or for that matter even non-existent. The Courts have usually avoided an unwarranted interference in matters having an expressed presence of LDs' lest that be seen as an undue judicial obstacle to the freedom of contract. As long as the contract containing the LD clause is valid and provided that the circumstances requiring such payment have arisen, the Courts generally do not interfere with the monetary sum agreed upon by the parties.

In a case where the clause is interpreted to be a 'Penalty' the legal effect would differ. A penalty is a security for contractual performance. The promisee would be indemnified if he/she recovers the actual loss, at the same time he/she will be presumed to have acted unconscionably if he/she attempted to recover a contractually agreed monetary sum which is disproportionate to the amount of damage suffered. Thus, it follows by inference, that in a scenario where the amount of penalty is more than the damage suffered, the claimant party could only recover the actual amount of damage suffered. An obvious enquiry following from this would be as to what happens in a situation where amount stipulated as penalty is less than the actual damage. Early English decisions, do not offer a concrete and

consistent jurisprudence on this. However, the case of *Cellulose Acetate Silk Co. Ltd.,* v. *Widnes Foundry (1925) Ltd..,*[5] seems to suggest that in probability the claimant would not be limited by the penalty and would have the right to sue for actual damage, provided the clause concerned is not in the form of a limitation of liability.

The case of *R* v. *London Guarantee and Accident Co., Ltd*.[6] explains that for payment of LDs' the 'burden of proof' would shift from the claimant party, as he/she is not required to prove any damage. On the contrary, for payment of Penalty the claimant must prove the existence of damages.

Indian Jurisprudence:

In Balkishan Das, the Constitutional Bench of the SC was presiding over a factual matrix concerning the interpretation of a clause in a sale deed which provided that should the vendee fail to get the deed registered by the stipulated date an amount of Rs. 25,000 would stand forfeited. The break-up of this amount was in the form of Rs. 1,000 as earnest money and Rs. 24,000 which was to be paid out of the price on delivery of possession. The learned judges interpreted the clause which provided for forfeiture of the money as a Penalty and not a LD. In doing so the Court relied on Section 74 of the Contract Act. Interpreting Section 74, the Court emphasized on the words: "*as the case may be, the penalty stipulated for*" and held that these words widen the operation of the provision and make it applicable to all stipulations by way of penalty. This may be in the form of payment of money or forfeiture of the money already paid.

In cases where the LD clause is interpreted to be a Penalty, the Court would have to decide an amount of reasonable compensation which would be lesser than the monetary sum. It was further observed by the learned judges that the proof of actual damage is not a statutory requisite under Section 74 and mere proof of a legal injury suffered would suffice in claiming compensation under the provision.

The SC was faced with the interpretation of a LD and Penalty clause for a second time in the Maula Bux case. The three judge bench in this case was faced with a similar scenario where the paid money had been forfeited under a contractual agreement. The learned judges, using Section 74, again interpreted this clause to be a Penalty. In doing so, they interpreted the words "*whether or not actual damage or loss is proved to have been caused thereby"* and observed that while a person, under this provision is not required to prove actual loss/damage in order to claim a decree, the Court is empowered to award reasonable compensation in the event of breach even when no actual damage is proved to have been suffered in consequence of such contractual breach. In a situation where the Court would be unable to assess the adequate compensation, it may take into consideration the sum named by the party in the agreement as a measure of reasonable compensation, as long as the sum is a genuine pre-estimate. However, this cannot be done if the sum is expressly termed as a Penalty. In a situation where the damage caused can be determined in terms of money the claimant must give proof of such damage.

In the Saw Pipes case, the SC made pertinent observations on the concept of LDs' that if the parties are well aware that a particular loss is likely to arise from a potential contractual breach, they may agree upon the payment for its compensation. *Moreover*, the necessity to submit evidence may not be mandatory in such situations unless the learned judges hold to the effect that the no loss could have been caused because of the event which triggered the LD clause. *Further*, in a scenario where the contractual agreement expressly states that the amount stipulated for a breach is a pre-estimated genuine LD and not a Penalty the claimant cannot be mandated to given proof of actual loss. *Lastly*, in situations having a pre-estimated LD clause the Court opined that the burden of proof would lie on the opposing party to demonstrate that no such loss is likely to occur upon the contractual breach.

It would be pertinent to note that in *Balkishan Das* the Court clearly stated that under Section 74 the claimant would still have to prove the existence of a *legal injury* even if he/she does not give proof of the actual damage being caused. To that effect, one might comment Saw Pipes did not deviate from *Balkishan Das* in holding that existence of a genuine pre-estimate in the LD Clause, may dispense with the requirement of proving evidence to prove loss unless the bench opines that there may not be any legal injury suffered by a claiming litigant.

In the Kailash Nath decision the SC was faced with the question whether a loss must mandatorily be proven in every case even when the contractual agreement contains a genuine pre-estimate of loss in the form of a LD clause. The Court, in this case held that compensation can only be granted for damage or loss suffered. In the absence of any loss, the law does not provide for a windfall gain.

As far as the determination of compensation by way of liquidated damages in breach of contractual agreements is concerned, the SC in a catena of decisions leading up to the *Fortune Infrastructure and Ors.* v. *Trevor D'Lima and Ors. (2018) decision noted, that an adjudicatory authority must follow a balanced approach while computing damages for breach of contract. Thus, the damages under contract law (whether liquidated or unliquidated) need to be compensatory or restorative in nature and cannot be excessive.*

Concluding Remarks:

On an ending note, one observes that the judicial evolution of our understanding of LDs' and Penalties has been quite multi-layered. The latest decision in *Kailash Nath* does not go without raising jurisprudential concerns. In hindsight, one wonders about the very purpose of having a stipulated monetary sum should the claimant party, in every case, be required to mandatorily give proof of actual loss caused by contractual breach.

In any event, this was a case where the learned judges held the contractual breach itself to be unfounded. This aspect raises question to its precedential value in matters concerning Section 74 as the statutory provision itself necessitates the existence of a contractual breach in the first place.

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[1] [1892] 1 Q.B. 127. Please refer to Lopes J's opinion at p.132.

[2] [1905] A.C. 6. Please refer to p. 9.

[3] [1915] A.C. 79. Please refer to p. 87.

[4] [1882] 21 Ch.D. 243.

[5] [1933] A.C. 20.

[6] [1920] 2 W.W.R. 85.