

Enforcing a claim for liquidated damages in India: key messages

Back to Asia Pacific Regional Forum publications

(/Regional_Fora/Regional_Fora/Asia_Pacific_Forum/Publications.aspx)

Naresh Thacker

Economic Laws Practice, Mumbai

nareshthacker@elp-in.com (mailto:nareshthacker@elp-in.com)

Ria Dalwani

Economic Laws Practice, Mumbai

riadalwani@elp-in.com (mailto:riadalwani@elp-in.com)

Quiet often, long after a dispute has arisen and claims have been filed, the innocent party, confident in its thought that liquidated damages are provided for in the contract, realises that its claim for such damages is unworkable, nay unenforceable. It is at that juncture that parties and their lawyers delve into questions such as:

- When the clause provides for a genuine pre-estimate of loss or damages is there still a need to prove it?
- What is the extent of a court's jurisdiction to award compensation on a clause on liquidated damages?
- What is the measure of damages under section 74 of the Indian Contract Act, 1872 (Contract Act)?

This article's authors have been asked another question on many occasions by drafters of these clauses: 'Is there a real difference between section 73 of the Contract Act, which deals with unliquidated damages in juxtaposition to section 74?' It is these and the myriad of other questions on the substance of section 74 that has prompted this article. We will seek to elucidate some of the key elements of the provision on liquidated damages, which have derived from various court precedents.

The consequences of breach of a contract are to be found in Chapter VI of the Contract Act. The chapter is divided in three distinct parts. Section 73 and 75 respectively, deal with compensation for loss or damage arising on account of breach and compensation for damage that a party suffers on account of non-fulfilment of a contract after such party rightfully rescinds the contract. Section 74 on the other hand, is available when the contract provides for a pre-determined amount as compensation, or where there is any other stipulation by way of penalty.

The earliest authority on the issue of liquidated damages was rendered by the Supreme Court in *Fateh Chand v Balkishan Dass*[**1**] and the principles laid down have endured for over half a century. The latest precedent is the 2015 decision of the Supreme Court in *Kailash Nath Associates v Delhi Development Authority and Another*,[**2**] which follows *Fateh Chand* and further clarifies the scope of the provision. In the decades

between these two cases, various courts across India have been called on to adjudicate contractual clauses on liquidated damages or stipulations of penalty. Several of these reached the Supreme Court and some of the other important decisions which dwell on the issue and its effects will be considered in the paragraphs below.

In *Fateh Chand*, the Supreme Court considered section 74 as it stands and contrasted it with the position under English common law. It found that under English common law, a mutually agreed genuine pre-estimate of damages is considered by courts as liquidated damages and claims thereon are sustained. Stipulations in a contract *in terrorem* are treated as penalty and courts refuse to enforce such clauses, awarding only a reasonable sum as compensation. According to the Supreme Court, section 74 is a conscious attempt by the legislature to move away from complex rules and presumptions under English common law, to distinguish between stipulations providing for liquidated damages and those in the nature of penalty. Section 74 provides uniform principle which apply to named sums as well as any other stipulation in the nature of penalty.

In India, the clear principles that emerge from the line of precedents on the subject can be summarised as:

- legal injury is an absolute essential for award of compensation under section 74;
- section 74 merely dispenses with the proof of 'actual loss or damage', it does not justify award of compensation when no legal injury results as a consequence of breach;
- the party complaining of a breach can receive a named amount as compensation in instances where exact loss or damage is difficult to prove, provided it is a genuine pre-estimate of damage, fixed by both parties and found to be so by court;
- in other instances, the measure for damages is 'reasonable compensation', subject to the limits set out in the clause on liquidated damages. Such compensation is to be fixed on settled principles found, inter alia, in section 73;
- while awarding compensation due regard is to be given to conditions existing on the date of breach;
- jurisdiction of courts to award compensation is unqualified except as to the limit stipulated;
- section 74 is available to both plaintiff and respondent in a lawsuit; and
- the provision applies with equal force to amounts already paid or those payable in future.

The bone of contention in almost all cases has been the use of the expression 'whether or not actual damage or loss is proved to have been caused thereby' in section 74. The question uppermost in the minds of people dealing with clauses on liquidated damages is: 'What is the reason for courts to delve into the issue of reasonable compensation when an amount, which is termed as a "genuine pre-estimate" is already stated in the contract?' This is usually followed by: 'Is it not counterintuitive to seek to fix compensation by reference to section 73 despite there being a named sum in the contract?'

In *Maula Bux v Union of India*,^[3] the Supreme Court explained that the expression is intended to cover different classes of contracts. In case of breach of some contracts it may be impossible for the court to assess compensation arising from the breach. It is in these circumstances that the sum named by parties may be taken into consideration as the measure of reasonable compensation, provided it is a genuine pre-estimate and not in the nature of a penalty. Where loss in terms of money can be determined, the party claiming compensation has necessarily to prove the loss suffered and in such instances, the courts are bound to assess the reasonableness of compensation claimed. It is while doing so that the courts will apply the principles

under section 73. It is important to understand that the courts are reluctant to countenance a position that is predicated on making a windfall out of a contractual breach. Therefore, unless damage or loss is shown to have been suffered, and the extent thereof measured and assessed, the courts will refuse to enforce a clause on liquidated damages. What also needs to be borne in mind is that this principle applies to both named amounts in contract as liquidated damages as well as any other stipulation in the nature of a penalty. Further in either case, the liquidated amount or penalty is the upper limit and the courts cannot grant compensation beyond that amount.

In *Fateh Chand*, the Supreme Court was faced with another question, whether section 74 applies to stipulations for forfeiture of amounts deposited or paid under the contract? While it was argued that the provision addresses the right to receive reasonable compensation from the party which has broken the contract and not the right to forfeit what has already been received by the party aggrieved; the Supreme Court held that the expression 'the contract contains any other stipulation by way of penalty' applies to every condition involving a penalty whether it is of payment in the form of money upon breach of contract, or delivery of property in future, or for forfeiture of right to money or other property already delivered.

One of the other tests to sustain a clause on liquidated damages is to ascertain whether it was mutually agreed upon by the parties possessing equal bargaining power. In *Phulchand Exports Limited v O O O Patriot*, [4] the Supreme Court was concerned with a clause of contract where under upon the seller's failure to deliver the shipment, reimbursement of the amount paid by the buyer under the contract was granted by the arbitrator. The seller sought to set aside the award on the grounds that it was punitive and, therefore, contrary to public policy. The Supreme Court considered section 74 of Contract Act and held that the clause for reimbursement was neither in the nature of threat, nor was it in the nature of penalty. Moreover, the court observed that even in the absence of such a clause, where the seller has breached their obligation at the threshold, the buyer is entitled to the return of the price paid plus damages.

While determining whether a transaction is contrary to 'public policy', the Supreme Court held that when experienced business people enter into commercial contracts and have equal bargaining power, the agreed terms of contract must be respected as the parties may be taken to have had regard to the matters of their knowledge.

Parties committed to reducing litigation and providing commercial certainty opt for a liquidated damages clause in commercial contracts, particularly when the sector is subject to regulatory regimes such as telecommunications.

While determining the nature and enforceability of a liquidated damages clause contained in an interconnect agreement, the Supreme Court in *Bharat Sanchar Nigam Limited v Reliance Communication Limited*, [5] clarified that before demarcating a damages clause as liquidated damages or penal, the concept of pricing and level playing field must be considered. In *Bharat Sanchar*, the Court held that the loss was measured based on costing and pricing, and since the amount represents a pre-estimate of reasonable compensation, section 74 was not violated. Moreover, when the damage is difficult to calculate, it enhances the presumption that the agreed sum is a genuine attempt to estimate the loss and overcome difficulties of proof at the time of trial.

As an aside, the drafters of clause on liquidated damages should bear in mind that, in India there are Goods and Service Tax (GST) implications on the payment of such damages under a contract, and that among other factors, contractual terms are relevant to judge whether the payment of liquidated damages would attract

taxation. In this respect it is relevant to consider the decision of the Appellate Authority for Advance Authority in the case of *Maharashtra State Power Generation Company Limited*, which determines the burden of GST under the Central Goods and Service Tax Act, 2017, on the payment of liquidated damages.[6]

In conclusion, to ensure that an enforceable claim of liquidated damages arises at the end of a hard-fought litigation, it is necessary to spend some time on the clause on such damages when it is being drafted. The principles outlined above, come from some of the most important decisions on this point in the jurisdiction and, if followed assiduously, will assist in ensuring enforcement of a decree/award of amount as liquidated damages before the Courts in India.

Notes

[1] AIR 1963 SC 1405.

[2] (2015) 4 SCC 136.

[3] (1969) 2 SCC 554.

[4] (2011) 10 SCC 300.

[5] (2011) 1 SCC 394.

[6] 2018 (17) G S TL 451.

Similar topics

[Asia Pacific \(/Search/Taxonomy.aspx?Taxonomy=Asia Pacific&TaxonomyUid=bee16022-8e9d-4702-867e-390ba8537072\)](#), [Asia Pacific Forum \(/Search/Taxonomy.aspx?Taxonomy=Asia Pacific Forum&TaxonomyUid=e4fa23cf-948f-47d7-8b95-e07eb8daa8fa\)](#)

Similar articles

IBAHRI urges Australian PM to reconsider refugee relocation policy to Cambodia
(/Article/NewDetail.aspx?ArticleUid=f705ed8a-0ec5-4ed4-8894-b4c1d3c287a9)

IBAHRI calls on international community to maintain pressure on Myanmar following UPR
(/Article/NewDetail.aspx?ArticleUid=a546c2e9-4724-4a9c-bada-b6a386be09fd)

IBAHRI legal specialist to help Timor Leste establish first national bar association
(/Article/NewDetail.aspx?ArticleUid=74f5f08f-65b5-4ed1-a977-4cfc2659eb58)

IBAHRI report highlights extent of corruption in the Cambodian judiciary
(/Article/NewDetail.aspx?ArticleUid=fb11e885-5f1d-4c03-9c55-86ff42157ae1)

IBAHRI examines the roles and responsibilities of Bar Associations in a comparative report
(/Article/NewDetail.aspx?ArticleUid=35a5e6bb-275e-4636-95b7-eb4d2ad5ebbf)
