

Liquidated Damages – A Chimera without Proven Loss

Contributed by: Vikas Goel and Abhishek Kumar

The present article aims at discussing various issues that invariably arise concerning a provision/term in the contract on 'Liquidated Damages' ("LD"). The first and foremost being 'if the whole of the LD provided in the contract is recoverable by the aggrieved party without proving the actual losses suffered by it'. The expression 'Liquidated Damages' is not per se defined under the Indian Contract Act but the relevant Sections, i.e. 73 and 74 which are extracted below, set out the elements, which constitute LD.

Section 73 provides as under:

"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 or 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".

Section 74 of the Contract Act reads as under:

"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 provided to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named, or the case may be, the penalty stipulated for."

For a better understanding of the concept of LD it will be useful to look at the definition of 'Liquidated Damages' in The Black's Law Dictionary, and the same is as under:

"An amount contractually stipulated as a reasonable estimation of actual damages to be recovered by one party if the other party breaches; also

If the parties to a contract have agreed on Liquidated Damages, the sum fixed is the measure of damages for a breach, whether it exceeds or falls short of the actual damages."

A perusal of the above clarifies that LD is nothing but a pre-estimated damage, which the parties agree while making the contract, as likely to arise in case of a breach.

The Courts, while dealing with the issue of validity of imposition of LD by one party to the contract on the other, read Section 73 & 74 of the Contract Act together.

Under the Indian Law, the damages are awarded to recompense the aggrieved party. In other words, the aggrieved party has to be placed, as far as the money can do, in the same position in which it would have been if no breach had occurred. As a necessary corollary, it means that the damages are to compensate the aggrieved party for the consequences directly and naturally arising from the breach and no one can be allowed to make an unjust enrichment under the garb of claiming compensation for a breach.

The definition in Section 73 of the Indian Contract Act necessarily pre-supposes that the damages are payable only if some loss has been occasioned by the breach. Succinctly stated, the principle is - No loss from the breach no damages. The same principle would, therefore, apply to a case of LD i.e. to be entitled to claim LD the aggrieved party must prove that it had suffered some loss arising out of the breach. To put it differently,

even the LD cannot be claimed if it is proved that no actual damages were caused by the breach as held by the Delhi High Court in **[Indian Oil Corporation Vs. Messrs Lloyds Steel Industries Limited; 2007 (144) DLT 659]**. In this case the Court held mere delay in construction and commissioning of the terminal at Jodhpur by the contractor did not entitle IOC to recover Liquidated Damages because there was no loss suffered by IOC. The Court found that pipeline reached Jodhpur terminal (on 31.8.1996) much after the date of completion of construction (31.3.1996) and the terminal could not be put to commercial use without pipeline reaching the terminal.

Few questions/concerns that generally arise concerning LD and our response thereto are mentioned herein below:

1. Difference between LD and a Penalty

A question frequently asked is 'what is the difference between LD and a Penalty'. While the LD is a pre-assessed loss agreed to between the parties at the time of making a contract, as likely to arise from the breach. On the other hand, a Penalty is a stipulation in the contract in the nature of terroram. A Penalty, generally speaking is a stipulation to award an imposition which is so disproportionate or excessive that no prudent person would consider the same as a reasonable assessment of damages arising out of the breach. For example, a stipulation in the contract providing that the party in breach would be liable to pay ten times of the contract price to the aggrieved party in case of a breach is in the nature of Penalty. Therefore, while both the LD as well as a Penalty are based on the stipulations mentioned in the contract itself, there is a stark distinction between the two terms. LD represents reasonable stipulation of likely losses, a Penalty is far from being reasonable and is intended to secure performance of the contract.

2. Whether the use of expression "genuine pre-estimate of likely damages" is essential or indicative of a stipulation in the nature of LD?

More often than not, a party opposing imposition of LD raises a point that unless the contract clause, which is said to be providing stipulation for imposition of LD, uses the expression "genuine pre-estimate of likely losses", it cannot be considered as a provision for LD. The parties then attempt to equate every such provision with that of Penalty to avoid imposition of damages as provided under the contract. Whether a provision is in the nature of LD or is a stipulation as a Penalty has to be seen from the quantum of damages provided for therein. Mere use of expression "genuine pre-estimate damages agreed between the parties" is not at all determinative of the nature of stipulation. The Court before which such stipulation is challenged will have to decide the same based on the facts and circumstances of each case and the relevant contractual clause. To qualify as a provision for LD, it must pass the test of being 'reasonable estimation of the parties'.

3. Can the Liquidated Damages be reduced proportionately depending upon the status of performance of the contract till the date of imposition of Liquidated Damages?

Another concern that engages the attention of the Courts and the Arbitrators is whether the amount of Liquidated Damages provided for under the contract can be reduced proportionately depending on the quantum of work done till the date of occurrence of breach. While it is true that wherever it is possible to prove actual damages, the party claiming LD will have to prove the losses actually suffered by it and confine its claim to that limit alone and not the full amount of agreed Liquidated Damages. However, it would not be correct to state that the provision of LD would itself get proportionately reduced depending on the quantum of performance achieved till the date of breach. This would amount to re-writing the contract, which is not permissible in law. Furthermore, such concept goes contrary to the basic idea of providing the LD, i.e. the parties taking informed decision at the time of entering into a contract and providing for pre-estimated damages.

4. Whether LD can be recovered without proving actual loss?

The Courts have repeatedly held that the provision for LD is not different from non-liquidated damages and in both the situations i.e. LD and non-Liquidated Damages, breach and the damage has to be proved [**Egon Zhender Internaional Pvt. Ltd. Vs. Namgayal Institute For Research On Ladakhi Art and Culture; 2013(4) Arb.L.R. 273 (Delhi)**]. However, when in certain situations it would be impossible for the Courts to assess the compensation arising from the breach, the Court can award the full liquidated damages if it is found to be a genuine pre-estimate by the parties as a measure for reasonable compensation. In *Oil & Natural Gas Commission v. Saw Pipes Ltd – (2003) 5 SCC 705*, the Supreme Court held that Arbitral Tribunal was wrong in refusing to award LD in favour of ONGC for want of proof of actual losses. Supreme Court held that delay in deployment of rigs resulted in change of the actual production of gas by ONGC. The Apex Court held that in such contracts it would be difficult to prove exact loss and after finding that the compensation provided for in the contract was not unreasonable, the Court upheld imposition of LD by ONGC on Saw Pipes Ltd.

5. Whether in all cases the Courts should allow full amount of Liquidated Damages?

The answer to the above question is obviously in the negative. Merely because the stipulation of LD is available in the contract, the aggrieved party cannot claim full amount of Liquidated Damages as a matter of right. Its entitlement would be to recover damages only to the extent of actual losses proved to have been suffered by it. In those cases, where no actual loss is proved, but undeniably losses have been caused, the Courts would not be powerless to award reasonable damages to the aggrieved party. There can be yet another type of situation i.e. where the nature of contract is such that assessing damages is not possible. In such a situation, the Court would be empowered to grant full amount of Liquidated Damages provided it is of the view that the same are fair and reasonable pre-estimate of damages agreed between the parties. [**Herbicides (India) Ltd. vs. Shashank Pesticides Pvt. Ltd. 180 (2011) DLT 243**].



Vikas Goel

Partner

vikas@singhania.in



Abhishek Kumar

Associate Partner

Email: abhishek@singhania.in