

Contractual Penalties, Actual & Liquidated Damages: Walking the Fine Line

1. Introduction

The debate surrounding contractual penalties, actual damages, liquidated damages or LDs has been a never-ending one. Contracting parties are always keen to get to the dotted line and sign and, in the process, sometimes, due attention is not given to some key, pure “legal” provisions which are considered “boilerplate.” Organizations have their own metrics of risk assessment and while some time is invested on these provisions, it is not enough, and realization may dawn when it is too late. In other words, the importance that the parties understand the efficacy of the agreed clauses cannot be underscored enough and that complete understanding of consequences must exist before signature. This requires going back to the fundamentals – the position under Indian law on LDs, can they be the sole remedy of an aggrieved party, is there a need to state specifically that such damages shall remain the sole remedy? Additionally, will LD payment preclude contract termination for default before the maximum cap is attained and does Indian law permit a party to claim both LDs and other damages for delays. What happens when a party seeks more than the contractually capped amount?

This newsletter discusses some of the foregoing basic and yet, not-so-obvious questions.

2. An Overview

In any contract for sale of goods, the fundamental statutory provisions are contained in sections 55 to 61 of the Sale of Goods Act (“**SOGA**”) that provide for action for breach of a contract. Then, sections 73 and 74 of the Contract Act (“**Act**”) read together provide for general principles when fixing the damages. The basic objective enshrined in both the legislations is to place the aggrieved party in the same position as if there was no default. Indian courts have also awarded damages for non-acceptance of goods, for non-delivery and even specific performance subject to the provisions of Specific Relief Act (“**SRA**”). Section 23 of SRA provides that provision of LDs shall not act as a bar against one seeking specific performance if the court is satisfied that the purpose of the LDs was not to eliminate the remedy of specific performance by giving an option to the defaulting party to pay money in lieu thereof.

In most contracts, parties often agree that in the event of a breach the defaulting party shall pay a stipulated sum to the one aggrieved as penalty. The essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party, while the essence of LDs is a genuine covenanted pre-estimate of damages which the parties can agree in advance. Under Indian law, contractual penalties are enforceable but section 74 of the Act provides that though predetermined figures may be provided, the court may award reasonable compensation not exceeding the stipulated amount regardless whether the actual extent of loss or damage is proved. Hence, LDs serve as a ceiling and while parties may stipulate them the courts have discretion to award damages which it considers reasonable, provided they do not exceed the stipulated amount. In the event of a breach, the court will examine the contract to fathom the intent of the parties and, once the fundamental issue of breach is established, it will decide on the quantum.

As far back as 1970, the Supreme Court of India took the position that all LDs need to pass the test of a genuine pre-estimate of loss as the purpose of such clauses is to promote certainty in

commercial contracts.¹ There are two different classes of contract which comes before the court i.e., where it is impossible for the court to assess compensation arising out of breach and where the compensation can be calculated. Where LDs are provided, the burden of proving that the damage is ascertainable lies on the defaulting party. Section 74 does not distinguish between damages and LDs and while granting damages, as noted, Indian courts allow only reasonable damages irrespective of the fact whether a contract provides LDs or not. When a court finds that it is unable to assess the compensation, it will award contractually agreed LDs. However, when it can be determined, then the aggrieved party must prove the actual loss/penalties arising from breach.

The concept of LDs recognized in Indian law emerges from jurisprudence. An important judgment in this regard is *Union of India v. Raman Iron Factory*² where the parties executed a contract for the supply of goods to the Union of India by Raman. Some disputes arose between the parties and the Union of India made a claim to recover the amount stipulated in the contract for breach. The matter went up to the highest court where the claim was not allowed by the Supreme Court and while deciding whether the Union was entitled to such claim or not, the court made the following observation on Section 74 of the Act:

“Section 74 of the Act eliminates distinction between liquidated damages and unliquidated damages. It establishes a uniform principle applicable to all stipulations naming amounts to be paid in case of breach, and stipulations by way of a penalty, and according to this principle, even if there is a stipulation by way of liquidated damages, a party complaining of breach of contract can recover only a reasonable compensation for the injury sustained by him, the stipulated amount being merely the outside limit.”

From the foregoing, it can be inferred that mere existence of a contractual provision is insufficient to claim LDs in proceedings unless actual loss is established by the affected party.

3. Other Pertinent Considerations

Parties would do well to evaluate some other possibilities and understand the corresponding position before closing the negotiations on these clauses.

3.1 *LDs as sole remedy:* Payment of LDs may not necessarily be the sole remedy of a party. LDs are a helpful legal tool and their provisions are often designed to address very specific types of breaches or establish a gradient of damages based on the degree of a breach. As noted before, they provide a reasonable pre-determined damages award, adding greater predictability, clarity, and above all deterrent value to a contract. Such provisions guard against delay in performance, outright failure to perform, and a variety of other breach situations. The value of the damages' clause does not accurately reflect what “actual” damages would be upon breach. They need to be and often are a reasonable approximation of harm suffered, they should be specific and/or set out a specific formula, and they should not seek to penalize the breaching party.

3.2 *Specific Performance:* Section 21 of SRA enables a party to seek compensation in addition to, or in substitution of, specific performance and the court may allow the plaint to be amended at any stage of the proceedings to incorporate such a claim. The court may also award compensation when the merits of the case do not warrant specific performance. However, the court may also award compensation in addition to the specific performance. Under section 10 of SRA, performance is

¹ Maula Bux Vs. Union of India, AIR 1970 SC 1955

² AIR 1974 SC 1265

available when **(a)** there is no standard for ascertaining the actual damage caused by non-performance of the promise **(b)** compensation in money would not be an adequate relief for non-performance. Specific performance is an equitable relief given by the court to enforce against a defaulting party defendant, the duty of doing what he agreed by contract to do. In view of the foregoing and given the propensity of the courts to look at the totality of the contract, where the goods supplier wants to limit the exposure, it is prudent to specify that LDs are the sole remedy. If a dispute arises, the burden of proof will fall on the defaulting party to prove otherwise.

3.3 *LD Payments & Contract Termination:* The right of an aggrieved party to terminate the contract, whether before or after the maximum amount of LDs have been reached would depend on a host of factors, notably if there are valid reasons and if the breach is a material one. It would also depend on the termination provision. Clearly, if right to terminate has to be exercised, it is in the best interest of the party who has suffered loss due to a default and claimed LDs to terminate once the maximum sum is reached. This will avoid lengthy litigation to recover the actual loss exceeding the pre-estimated damages. As a matter of practice, right to terminate should be a limited one and neither party should be permitted to renege from its obligations easily.

3.4 *LDs and “other” damages related to delay:* The fundamental principle underlying damages is that a party which has sustained losses due to a breach of contract, has to be placed in the same position that he would have been in, had the contract been performed. The function of damages is compensatory and not punitive. Once LDs are awarded, no claim for damages by way of loss of profits or other incidental damages will lie for the same breach. While assessing damages, the court is obligated to oversee that the limit of the penalty stipulated is respected and is reasonable having regard to all the circumstances of the case. Jurisdiction of the court to award compensation in case of breach of contract is unqualified except as to the maximum stipulated. Thus, while an affected party can claim damages, but the right to receive cannot exceed the pre-determined amount stipulated in the agreement. Jurisprudence further affirms this. For a party to claim and receive LDs and other damages, it is important to be cognizant of the rule in section 73 of the Act which provides for the sum of compensation recoverable under this section: **(a)** damages recoverable must be such as naturally arise in the usual course of things from the contract breach or, **(b)** which the parties knew when they made the contract, to be likely to result from the breach or, **(c)** such damage must in neither case be remote or indirect and, **(d)** in both cases, the means which existed of remedying the inconvenience caused by non-performance of the contract, is to be factored.

3.5 *Party’s right to choose actual damages instead of LD’s:* By providing for specific and capped LDs in a contract, the parties aim to eliminate the option of award of “actual damages.” This, then, precludes the right of the aggrieved party to claim any other sum not specified or ascertained. The established Indian judicial position is that LDs promote certainty in commercial contracts since parties fix a sum in advance because it facilitates risk calculation, mitigates the difficulty and expense involved in proving actual damage or loss and facilitates speedy recovery of damages. It also avoids the difficulty in assessment, even where the consequences of breach are ascertainable and avoids the risk of under-compensation. Further, it works as a security that in case of any breach, parties are entitled to the sum mentioned to cover for the losses suffered by them. And, finally it also serves as a deterrent to avoid breach. In a very important case, the Supreme Court stated rather succinctly, i.e., where the contractual stipulation is in the nature of penalty, the aggrieved party is still entitled to invoke the conventional remedy of unliquidated damages, but if the stipulation is one of LDs, the provision excludes the claim of unliquidated damages for that breach.³

³ ONGC Vs. Saw Pipes 2005 SCC 705

3.6 *Seeking More than the capped amount:* Often a question arises if a party has any right to ask for more than the capped amount by showing that damages sustained far exceed the capped figures. While a party can always ask, but it will not have a valid right. In every agreement in which a sum is already named as damages to be paid in case of breach of contract, the court cannot award more than reasonable compensation exceeding the amount so named.⁴ If the sum stipulated was found to be a reasonable estimate the aggrieved party is restricted to that sum even if actual loss is higher. In the end, the subjectivity of common law steps in, and one will do well to remember the discretion of the court having regard to the conditions existing on the date of the breach of the contract, depending on the facts and circumstances.

4. Conclusion

From the above it is clear that while parties agree and may provide predetermined damages in the contract, the reality of the loss incurred may be different. Should a dispute arises which is litigated, in all likelihood, the court will award reasonable compensation whether or not the actual extent of loss or damage is proved. The quantum of LDs serves as a ceiling and the courts have discretion to award the damages which it considers reasonable, provided they do not exceed the stipulated amount. The jurisprudential position is clear. Where the parties have deliberately specified the amount of LDs there can be no presumption that they, at the same time, intended to allow the non-breaching party to bid adieu to the sums specified and, instead, claim a sum which was not ascertained at the date of breach. The court will walk the fine line and in order to award a higher sum shall examine the totality of the contract execution, parties' intent, their respective performance or non-performance and conduct.

Author

Priti Suri

⁴ Fateh Chand Vs. Balkishan Das (1964) 1 SCR 515; Maula Bux Vs. Union of India (1970) 1 SCR 928