

Liquidated damages vs penalty: are causation and loss required

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In a contract, the parties may name a sum to be payable in the event of breach. If such sum is a genuine pre estimate of loss it is termed liquidated damages, and if it bears no reflection on the loss suffered, it is termed a penalty. Courts are reluctant to enforce penalty clauses and in such cases the sum stipulated is normally reduced.

It has been perceptively observed by Fansworth that in comparison to the bargaining power which parties enjoy in negotiating their substantive contractual rights and duties, their power to bargain over their remedial rights is surprisingly limited. They are not at liberty to name an extravagant sum having no relation to the breach, for fear of it being construed as a penalty. It is interesting to contrast this with the law relating to consideration.

A man may sell his car for a handful of marbles, and the law cares not, as long as he is satisfied. Yet the law would give no peace to a man who claims ten thousand rupees for failure to deliver a handful of marbles, branding such a clause penal. The Position in England It is stated in a standard work that the specification of damages by the parties does not exclude the rule that damages for loss are expected to compensate for actual loss suffered.

The major distinction between English and Indian law upon the point is that under English law, penalties are irrecoverable. In case of a penal clause, damages will be assessed in the usual way, and the plaintiff may even recover a sum greater than the stipulated amount. In discerning the true nature of the contract and the compensation payable, the court must have

regard to the terms and inherent circumstances at the time of the making of the contract and not at the time the breach occurred.

The terms used by the parties are not conclusive and the court is not bound by their phraseology. If a term is stated to be a penalty but turns out to be a genuine pre-estimate of loss, it will be treated as liquidated damages. Some rules for determining the true nature of the sum stipulated were laid down by Lord Dunedin in *Dunlop Pneumatic Tyre Co. Ltd. v. New Garage and Motor Co. Ltd.* :

(i) The sum will be a penalty if it is extravagant and unconscionable compared to greatest loss that could conceivably be proved to have followed from the breach; (ii) The clause will be penal if the breach entails not paying a sum of money and the amount to be paid as damages exceeds the sum which ought to have been paid; (iii) There is a presumption that the sum named is a penalty, when a single lump sum is made payable in cases of all breaches, irrespective of their nature or magnitude; and (iv) It is no obstacle to a sum being treated as liquidated damages that the consequences of the breach are such as to make precise pre-estimation an impossibility.

However, even under English law, a liquidated damages clause will result in the plaintiff recovering the stipulated sum without being required to prove damage and irrespective of any actual damage, even when actual damage is demonstrably smaller than the stipulated sum.

It is stated in the Chitty that the purpose of fixing a sum is to facilitate recovery of damage without the difficulty and expense of proving actual

damage; or to avoid the risk of under compensation, where the rules on remoteness of damage might not cover consequential, indirect or idiosyncratic loss; or to give the promisee an assurance that he may safely rely on the fulfillment of the promise.

A distinction is drawn between contracts which accelerate an existing liability to pay and those which create or increase liability to pay. The latter are penal, the former are not. In this context, it is also relevant to consider contracts which provide for forfeiture of amounts already paid. If the sum paid is penal and it is unconscionable for the payee to retain the money, equitable relief may be available. However, the genuine pre-estimate of damages test does not apply in such cases.

Nonetheless, courts will take into account whether the sum to be forfeited is much greater than the damage caused by the breach. As regards fluctuating sums, the position is stated in the *Chitty*, and is worth setting out in extenso: Although a valid agreed damages clause may specify a graduated scale of sums payable according to the varying extent of the expected loss, a sum which is liable to fluctuate according to extraneous circumstances will not be classified as liquidated damage.

In a railway construction contract it was provided that in the event of a breach by the contractor he should forfeit as and for liquidated damages certain percentages retained by the government of money payable for work done as a guarantee fund to answer for defective work, and also certain security money lodged with the government. The Judicial Committee held

this was a penalty, since it was not a definite sum, but was liable to great fluctuation in amount dependent on events not connected with the fulfilment of the contract.

It is obvious that the amount of retained money depended entirely on the progress of those contracts, and that further, as those moneys are primarily liable to make good deficiencies in these contract works, the eventual sum available could not in any way be estimated as a fixed sum Interestingly, however, graduated damages have been upheld as liquidated damages in building contracts and other similar contracts where the sums payable increase in proportion to the seriousness of the breach, e. g. sum which increases with each week of delay in performance , or proportional to the number of items involved.

Position in India Statutory codification in India resulted in the elimination of one distinction between liquidated damages and penalties observed in English law. As per s. 74 of the Indian Contract Act, 1872 (hereinafter referred to as the Act) irrespective of whether the stipulation is by way of liquidated damages or penalty, the court is entitled to award reasonable compensation, not exceeding the amount named in the contract.

As already pointed out, under English law only penalties may be reduced to reasonable compensation The Act also provides illustrations of what may be considered penalties 75% interest in case of default on a bond normally carrying 12% interest , doubling the amount to be delivered . Indian decisions tend to follow and incorporate the principles laid down in English

decisions. The leading text is replete with references to English decisions. The Hon'ble Supreme Court has held that if the parties regard a sum as reasonable, the Court should not reduce it in its discretion.

Where the clause is one for liquidated damages, there is no question of ascertaining damages and such a clause excludes the right to claim unascertained damages. A stipulation for payment of 1.5% per day on the value of goods in case of delay has been held to be a penalty. However, an additional charge of 1% per month in case of non-payment of bills was held not to be a penalty. Where the government would suffer loss which it would be unable to prove, a pre-estimate worked out on a percentage basis, for late supply of road building materials, was upheld as liquidated damages. This brings us to some dichotomies worthy of comment.

Firstly, it has been held that damages which are not a direct result of the breach, or are not within the contemplation of the parties cannot be recovered under s. 74. Secondly, there exist numerous statements, to the effect that some loss, though not proof of loss, is required before compensation is awarded under s. 74. This flows from the basic premise that damages are awarded only to compensate for loss caused. Similar statements are found in English law. On the first point it is submitted that to read these requirements of s. 73 into s. 74 would be erroneous as the acknowledged purpose of s. 4 is to allow the parties to recover damages which otherwise may not be awarded as being too remote or consequential rather than direct.

On the second point, it is submitted that a strictly textual reading of s. 74 of the Act does not divulge any requirement of loss. The words used are whether or not actual damage or loss is proved to have been caused thereby. S. 73, on the other hand, clearly requires loss and an unbroken chain of causation before damages are awarded. It is submitted that the correct interpretation would be to read s. 74 as an exception to s. 73 and dispense with the requirement of loss.

To say that actual proof of loss is not required, but some loss must be proved nonetheless is to walk a fine line. The statement is in fact slightly circular. To inquire into loss is to necessarily require proof of loss. It is arguable that freedom of contract must extend to being able to agree upon compensation in cases where no loss is caused. All loss, like all consideration, is not tangible or quantifiable. *ONGC v. Saw Pipes* This case arose out of a challenge to an arbitral award rendered with regard to a dispute relating to supply of equipment for offshore oil exploration by the Respondent.

The case was heard by M. B. Shah and Arun Kumar JJ. The judgment was written by Shah J. Facts The dispute arose out of the failure of the Respondent in supplying the said equipment as per schedule, due to labour problems in Europe. This led to the Applicant extending the time for delivery with the specific caveat that liquidated damages would be recovered. Liquidated damages to the extent of US \$ 3, 04, 970. 20 and Rs. 15, 75, 559 were later deducted from payments made for goods. The contract itself provided for recovery of a sum equivalent to 1% of the contract price of the

whole unit per week for each delay as agreed liquidated damages and not by way of penalty.

Such sum was to be deducted from the payment. (emphasis supplied) The Arbitral Tribunal concluded that the labour troubles would not be covered by the force majeure clause in the contract. However, it considered various decisions of the Hon'ble Supreme Court and concluded that the before the Appellant could recover liquidated damages it had to establish that it had suffered loss because of the breach. Upon appreciation of the evidence the Arbitral Tribunal concluded that such loss had not been proved and hence ordered payment, of the sum withheld as liquidated damages, to the Respondent along with interest.

This award was challenged before the Supreme Court as having been decided contrary to the terms of the contract and prima facie illegal.

Decision and Analysis The Hon'ble Court first extensively discussed the courts jurisdiction to set aside an award under s. 34 of the Arbitration and Conciliation Act, 1996 and the various grounds on which interference was permissible. Passing over to the question of damages, the Hon'ble Court opined that when the words of the contract are clear, there is nothing the court can do about it.

If the parties had agreed upon a sum as being pre-estimated genuine liquidated damages there was no reason for the Tribunal to ask the purchaser to prove his loss. It further opined that when the court concludes that the stipulation providing for damages is by way of penalty, it can grant

reasonable compensation upon proof of damage. However, where an agreement has been executed by experts in the field, the court should be slow to construe a clause providing for liquidated damages as penalty.

At para 49, citing *Maula Bux v. UOI*, the court concludes that this is especially true where the court is unable to assess compensation or such assessment is fraught with difficulties. In such cases the burden of proof would be on the party who contends that the stipulated amount is not reasonable. There was no such contention raised in the instant case. As regards forfeiture, after considering its decision in *Union of India v. Rampur Distillery and Chemical Co.* the Court states that forfeiture clause can be construed either as liquidated damages or as penalty, depending on the reasonableness of the amount to be forfeited.

Therefore, as regards liquidated damages and penalties, the primary conclusions of the court appear to be that liquidated damages should be regarded as reasonable compensation, while penalties should not. Further, it also appears to have concluded that in case of a penalty damages will have to be proved. The Hon'ble Court reaffirms that no compensation at all need be awarded if the court concludes that no loss is likely to occur because of the breach. The possible flaws in such a conclusion have already been discussed above.