

Liquidated Damages - Applicability and Enforceability

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INTRODUCTION

In all building and engineering contracts, it is invariably provided that the subject work shall be completed within the stated time. In order to ensure that the objective is achieved, the parties agree between themselves that a certain percentage of the amount of the whole work shall be completed at different defined stages. It is also provided that default in achieving the target by the contractor at any of the defined stages would attract action by the employer in terms of the liquidated damages clause contained in the contract.

The contracts generally provide that the contractor at 1/4 th, 1/2 and 3/4th stages of the work shall achieve defined progress. If at one-fourth stage, the contractor fails to give progress as agreed, the employer can levy liquidated damages, after observing the requisite formalities, or can, alternatively, call upon the contractor to make up the progress in a period to be given in the notice, failing which a right can be reserved by the employer to levy liquidated damages. Similar action can be initiated after the expiry of half or three-fourth of the stipulated period.

The purpose of inserting liquidated damages clause is only to ensure that the contractor shall execute the work with due diligence and in a workmanlike manner and strive to complete the whole work as given in the contract within the stipulated time. It must be remembered that the stipulation with regard to liquidated damages is not at all aimed to provide revenue to the employer. It is thus, desirable that recourse to imposition of liquidated damages should be taken only in extreme cases. It must be understood that by realising the amount of liquidated damages, the employer is not only reducing the working capacity of the contractor but is also running the risk of bringing the work to a complete halt. Many legal and financial complications can and do arise consequently. There may be an injunction from the Courts restraining the employer from proceeding with the work further pending' decision of the case. In addition, the risk of additional financial burden due to efflux of time has also to be borne in mind by the employer.

In many cases the time fixed by the contract ceases to be applicable on account of some act or default of the employer or his architect or engineer. A provision is, therefore, generally inserted in order to avoid such acts or defaults destroying the right to liquidated damages, by which the architect or engineer is empowered to grant an extension of time on the happening of certain specified events, and the contractor is bound, when such an extension of time has been properly granted to complete within the extended time. This has the effect of substituting for the time fixed by the contract a new date from which the liquidated damages are to run. Such a new date can only be substituted for the original time, under such a power, where the extension is given under the circumstances and on the happening of the events expressly provided by the contract. (1)

MERE USE OF WORDS "LIQUIDATED DAMAGES" AND "PENALTY" IN A CLAUSE NOT TO BE DECISIVE

The question that arises is as to what is meant by liquidated damages, and secondly, whether or not the stipulation in the contract is in fact for penalty or liquidated damages. Under Common Law, a genuine pre-estimate of damages by mutual agreement was regarded as a stipulation for liquidated damages, a stipulation in contract in *errorem* is a penalty and the Court refuses to enforce it, awarding to the aggrieved party only reasonable compensation

The use of the term penalty or liquidated damages by itself is not decisive, even what is described as liquidated damages could turn out to be penalty on the face of given case. The essence of penalty is a sum paid as *in terrorem* while the essence of liquidated damages is a genuine covenanted pre-estimate of damages. A penal stipulation cannot be enforced. Liquidated damages must be the result of a genuine pre-estimate of damages and they do not include a sum fixed in *terrorem*. The question is one of construction of a contract to be judged as at the time it was made, and mere description as penalty or liquidated damages though relevant is not binding.

The Indian Legislature has sought to cut across the web of rules and presumptions under the English Common Law by enacting a uniform principle applicable to all stipulations naming amounts to be paid in case of breach, and stipulations by way of penalty. (3)

Sometimes it becomes difficult to make out whether the sum named in a clause is a penalty or liquidated damages. In such a case, the Court must take into consideration the intention of the parties, as evidenced by their language and the circumstances of the case. (4)

Mere use of the word "penalty" in a liquidated damages clause would not make the stipulation penal. If the sum named is not *in terrorem* it would be regarded as liquidated damages despite the fact that it had been given the name "penalty" in the contract.

Where in a contract for electric lighting installation it was provided that the work should be "completed in all respects on or before 26 November, 1898, subject to a penalty of 15 pounds per day, and the Plant by 10 December, subject to a penalty of 3 pounds per day the work remains unfinished to the satisfaction of the authorities or the Engineer, it was held that although the word penalty was used, the amounts accrued owing to the default of the contractor were, in fact, liquidated damages. (5)

On the other hand, if the sum named in the agreement is *in terrorem* but has been stipulated to be liquidated damages in the contract, it will not be given effect to by the Courts since, in fact, it is in the nature of penalty.

Where the employer determined the contract on account of alleged breaches by the contractor, and clause 30 of the contract provided that in the event of the determination for breach, "all implements of the contractor used in the carrying out of the contract and all materials provided by him.... shall become the sole and absolute property of the employer and shall be considered as unascertained damages for breach of contract", it was held that the clause was a penalty clause and not a liquidated damages clause. (6)

DISTINCTION BETWEEN LIQUIDATED DAMAGES AND PENALTY

Sometimes there is a very thin line dividing provisions relating to liquidated damages and penalty. A distinction as to whether the stipulation is one by way of liquidated damages or penalty has been summed up by the House of Lords in *Dunlop Pneumatic Tyre Co. Ltd. Vs New Garage and Motor Company Ltd.* (7) as follows:

A. The parties who use the expression 'penalty' or liquidated 'damages' may prima facie mean what they say, yet the expressions are not conclusive.

B. The essence of a penalty is a payment of money *in terrorem* of an offending party; the essence of liquidated damages is a genuine pre-estimate of damages.

C. The question whether a sum is a penalty or liquidated damages is a matter of construction of the particular contract, to be judged at the time of its and not at the time of its breach.

D. To assist in this task of construction, various tests have been suggested, which if applicable to the case under construction may prove helpful or even conclusive. Some such tests are -

i) the sum stipulated shall be a penalty if it is extravagant and unconscionable in amount in comparison with greatest loss that could conceivably be proved to follow from breach.

ii) it would be a penalty if breach consists only in not paying sum of money and sum stipulated is greater than sum which ought to have been paid;

iii) presumption (but no more) that it is a penalty when single sum made payable by way of compensation, or occurrence of one or more or all of such events, which may occasion serious damage or trifling damage, on the other hand; and

iv) no obstacle to sum stipulated being a genuine pre-estimate of damage that consequences of breach are such as to make precise pre-estimation almost impossible. On the contrary, that is the situation when probably the pre-estimated damage was true bargain between parties.

A building contract contained a proviso that in case the contract should not in all things be duly performed by the contractors they should pay 1000 pounds as liquidated damages. Held, this was a penalty and not liquidated damages. (8)

If in making a provision for breach of contract, the promisee stipulates that the promisor on the breach only, shall pay such compensation as the Court would deem reasonable in the circumstances of the case, then there is no penalty and the stipulation is not penal. But, if on the other hand, the Court, after a proper consideration of the facts of the case, come to the conclusion that the stipulation was put in not by way of reasonable compensation to the promisee but in order that by reason of its burdensome or oppressive character it may operate *in terrorem* over the promisor so as to drive him to fulfill the contract, then such a stipulation is by way of penalty. (9)

The parties to a contract may at the time of entering into it provide, that in case of breach the party in default is to pay to the other a sum certain provided in, or ascertainable from, the contract. This sum may be either liquidated damages, in which case it is not to be interfered with by the Court, or a penalty, which covers the loss if proved but does not assess it. If it is a sum which can be regarded as a genuine pre-estimate by the parties of the loss which they contemplated would flow from the breach, it is liquidated damages. If, on the other hand, the sum does not attempt to assess the loss, but is imposed as security for the due performance of the contract, it is a penalty. Liquidated damages, therefore, are pactitional damages agreed to between the parties. Therefore, the essence of a penalty is a payment of money stipulated as *in terrorem* of the offending party; the essence of liquidated damages is a genuine covenanted, pre-estimate of damage. (10)

WHEN LIQUIDATED DAMAGES TREATED AS COMPENSATION FOR DELAY

In certain cases, the Courts have treated the liquidated damages as compensation for delay caused by the contractor in completing the work. By way of illustration, reference may be made to the two cases which are as under:

(A) The erectors of a silk reeling plant covenanted to pay 20 pounds a week- for every week exceeding eighteen weeks occupied in the erection of the plant. The, period was greatly exceeded, and the silk company contended that this sum was a penalty and that they were entitled to much larger sum as unliquidated damages. Held, the sum of 20 pounds a week was intended by the parties to be the agreed measure of damages as the erectors had declined to be responsible for delay and the sum was provided in place of no compensation and was not a pre-estimate of actual damages, but was an agreed amount to go towards compensation for delay.(11)

(B) Where a contractor entered into a contract with the Government for supply of materials before a specified date for the repair and construction of roads and the parties were aware that the construction work was a matter of extreme urgency and was to be completed with the help of materials to be supplied by the contractor before the specified date, otherwise the construction work would be held up and the Government would suffer loss and damages and also the parties knew before hand that if the contract would not be performed to its completion, it would not be possible for the Government to lead evidence of actual loss and accordingly they assessed such loss on the basis of certain percentage of value of contract and where there was sufficient evidence to prove illegal injury suffered by the Government by reason of the breach of the contract and also to show that if any other contractor had been employed at that stage, the Government would have suffered certain loss and damage thereby the amount assessed and mentioned in the contract cannot be said to have been assessed by way of penalty but was a genuine pre-estimate of the loss which was to be suffered by the Government in case of failure on the part of the contractor to deliver the materials before the due date mentioned in the contract. Hence, the amount mentioned in the contract would be payable as liquidated damages. (12)

DAMAGES NOT PAYABLE WHEN LIQUIDATED DAMAGES LEVIED

The parties when entering into a contract presuppose that the employer shall not commit any breach of conditions of contract and shall under all circumstances give effect to the stipulations contained in the contract. This is probably the only reason why the contract does not provide a yardstick for measuring damages which the contractor suffers like the manner it is so provided in case of liquidated damages. Thus, the only remedy available to the contractor in case of breach of contract by the employer is to submit his claim for damages to the arbitrator if the contract provides for arbitration in case of disputes between the parties but if there be no arbitration clause, then to file a civil suit. The question whether the employer in addition to the amount stated in the liquidated damages clause, is entitled to damages has been answered in *Sir Chunilal V. Mehta and Sons Ltd. Vs Century Spinning and Manufacturing Co. Ltd.* (13) in the following terms:

"Where the parties name in a contract reduced to writing a sum of money to be paid as liquidated damages they must be deemed to exclude the right to claim an unascertained sum of money as damages. The right to claim liquidated damages is enforceable under section 74 of the Contract Act and where such a right is found to exist no question of ascertaining damages really arises. Where the parties have deliberately specified the amount of liquidated damages there can be no presumption that they at the same time intended to allow the party who has suffered by the breach to give a go by to the sum specified and claim instead a sum of money which was not ascertainable or ascertainable at the date of the breach."

The effect of section 74 of the Indian Contract Act is that a party cannot get the full amount mentioned in the contract as a matter of absolute right or as a matter of course. But if the party proves that he has suffered damage to the extent of the full amount or that the Court considers, even without any proof that the full amount is a reasonable compensation which can be awarded under the circumstances, the Court can award the full amount. One thing is however certain, that the party is entitled to get some amount, not exceeding the sum named, which the Court considers as reasonable compensation, whether any actual loss or damage is proved to have been suffered by him. (14)

SITUATIONS WHERE LIQUIDATED DAMAGES CANNOT BE REALISED

Realisation of liquidated damages from the contractor is not a matter of course. There may be circumstances when the employer loses the right to recover the same from the contractor.

Liquidated damages cease to be payable where the employer has waived the right to insist upon them. e.g. where he has failed to deduct or retain them in cases where it is imperative on his part under the contract to do so.(15)

Where the liquidated damages are stipulated for at so much per day or per week, there must be a definite date from which they are to run. If no such date is fixed by the contract, or if by the operation of intervening circumstances the date fixed by the contract has ceased to be operative and there is no provision in the contract by which another date can be substituted, all rights to recover the sum stipulated for as liquidated damages have gone.(16)

A contractor was delayed and failed to complete the contract on time, partly because of his fault and partly because the employer was late in the delivery of certain fixtures in the building. The employer sued the contractor under a liquidated damages clause for a per diem payment of each day's work overdue. Held, the failure of the employer to deliver precluded him from relying on the penalty clause, notwithstanding that the contractor may have been overdue in any event, in the absence of evidence that the contract could have been completed in time by a special effort on the part of the contractor.(17)

When the contractor had not finished the work by the date fixed in the agreement and the State allowed him to continue and complete it and final bill was prepared without imposing any penalty in terms of contract soon after the contractor's failure to complete by fixed date or rescinding the contract or getting work completed by other contractor, the State was not entitled to compensation as it must be deemed to have waived its right to fix it and recover the same from the contractor.(18)

When a clause in the agreement provides that compensation shall be deducted from time to time as the delay would occur during the progress of the work, non-levy of the same by the Chief Engineer would amount to waiver of his right to fix the compensation and to recover the same from the contractor.(19)

There are many ways in which completion of the works within the contract time may be prevented by the act or default of the employer, as, for instance, by ordering extras, by not providing the site at the appropriate time; by failure to supply drawings when required by the contractor, or by failing to supply materials which the employer has agreed to provide. Where the effect of extras being ordered by the employer is to cause delay to the contractor, it is clear that, in the absence of special stipulations in the contract, the date fixed for completion is made inapplicable and the contractor is relieved from his liability to pay liquidated damages for delay.(20)

Where a clause in a contract provided for imposition of penalty if work was not done with due diligence, and the delay occurred due to failure of the department in supplying the stipulated material in time which had been duly intimated from time to time, and even the request of the contractor for grant of extension of time had not been rejected by the department, it was held that imposition of penalty for delay cannot be justified.(21)

LIQUIDATED DAMAGES RECOVERABLE ONLY WHEN LEGAL INJURY SUFFERED

The question whether the employer can recover the amount specified in the contract by way of liquidated damages without proving that there had been "legal injury" has been answered in some decided case. In *Fateh Chand Vs Balkishan Das* (22), the Supreme Court of India has held that Section 74 of the Indian Contract Act undoubtedly says that the aggrieved party is entitled to receive compensation from the party who has broken the contract, whether or not actual damage or loss is proved to have been caused by the breach. Thereby it merely dispenses with proof of "actual loss or damage". However it does not justify the award of compensation when in consequence of the breach no legal injury at all has resulted, because compensation for breach of contract can be awarded to make good loss or damage which naturally arose in the usual course of things, or which the parties knew when they made the contract, to be likely to result from the breach.

Section 74 of the Indian Contract Act, 1872 does not dispense with the basic condition of the breach resulting in any loss or damage which can be called "legal injury". The party complaining of breach of contract and claiming compensation is entitled to succeed only on proof of "legal injury" having been sustained on account of such breach. The words in Section 74 "whether or not actual damage or loss is proved to have been caused thereby" have been employed to underscore the departure deliberately made by the Indian Legislature from the complicated principles of English Common Law and also to emphasize that reasonable compensation can be granted even in a case where extent of actual loss or damage is incapable of proof or not proved. Thus, Section 74 deliberately states that what is to be awarded is a reasonable compensation. In a case where the party complaining has not suffered legal injury in the sense of sustaining loss or damage, there is nothing to compensate him, for there is nothing to recompensate, satisfy or make amends. Therefore, he will not be entitled to compensation.(23)

Where the Chief Engineer has very categorically stated that on account of the delay on the part of the contractor in completing the work, there occasioned, in fact, no loss to the Government, compensation cannot be granted by the Courts even if a sum is named in the contract as payable in the event of breach of contract.(24)

In *Michel Habib Raji Ayoub Vs Sheikh Suleman El Taji Forouqui* (25), it was observed as under:

"Agreed liquidated damages, if to be enforced must be the result of a genuine pre-estimate of damages' to use the illuminating phrase of LORD DUNREDIN. They do not include a sum fixed *in terrorem* covering breaches of contract of many varying degrees of importance the possible damages from which bear no relation to the fixed sum, which obviously have at no time been estimated by the contracting parties. It seems right therefore to conclude that now when the code is applied to contracts 'damages' will be taken to mean actual damages, and the article will only apply to an agreement which represent a genuine pre-estimate of damages'. Where there is such an agreed sum 'no more and no less' can be awarded. But if the Court applying well-known rules has to conclude that the sum agreed was a penalty, whatever it may be called in the agreement, then the penal stipulation shall not be enforced."

SECURITY DEPOSIT CANNOT BE FORFEITED WHEN LIQUIDATED DAMAGES LEVIED

The question whether security deposit of the contractor can also be forfeited when the employer has already exercised its right of recovering liquidated damages has been answered by the Courts in India. Some of the cases relating to this aspect of the matter are as under:

Where on failure of contractor to complete the work within time, the Government in accordance with conditions of contract debited the contractor with actual cost which was spent in getting unfinished work done and forfeited the security amount also, it was held that as the Government did not suffer any damage in consequence of default, it was not entitled to forfeit security deposit inasmuch as forfeiture of security deposit, would amount to imposition of penalty.(26)

The party to the contract taking a security deposit from the other party to ensure due performance of the contract is not entitled to forfeit the security deposit on the ground of default, when no loss is caused to him in consequence of such default.(27)

When in a works contract, the contractor undertook to complete the work within 3 months and on default to forgo the deposit and the building having been completed late without any loss to the department, it was held that the department could not forfeit the deposit and at best could claim reasonable compensation.(28)

A provision in the contract between the contractor and the government cast a duty on the contractor to finish the work within the specified time and if he failed to do so, the Divisional Engineer was given a discretion to cancel the contract and employ some other person to execute the remaining portion thereof. The Division Engineer could also recover from the contractor any extra cost that such proceeding might entail or he might allow the contractor to complete the work charging for each day for the work unfinished by him a penalty. The contractor not having completed the work within the stipulated time, the Government cancelled the contract. The government did not give the work to any other person nor did it allow the contractor to complete it. No notice was given to the contractor before the cancellation of the contract. The government, however, forfeited the earnest money and the security deposit which were deposited by the contractor, on the condition that the amount would be returned to the contractor upon completion of the work. It was held that though the government was entitled to cancel the contract, it had not followed the formalities laid down in the stipulations of the contract and therefore would not be entitled to forfeit the earnest money and further security deposit (29).

Where in a contract between the State government and the contractor, power had been conferred upon the Executive Engineer to grant extension from time to time and for levying and recovering penalty/compensation from the contractor at specified rates for the unfinished work after expiry of the fixed date, it was held that on rescission of, such contract by Government without fixing any further period was illegal and State Government committed a breach of contract and consequently the security deposit of the contractor could not be forfeited.(30)

To justify forfeiture of advance deposit being part of price as "earnest", the terms of contract should be sufficiently explicit and made known to the party making the deposit. Thus, where the contents of the reply submitted by the receiver in the Court were not sufficient to hold that 1/4 th advance deposit of bid money was by way of earnest and as a guarantee for fulfillment of other terms of the contract so as to justify its forfeiture on the alleged breach on the part of the highest bidder, then in the absence of proof of any loss to the auctioning authority the advance deposited by the auction-purchaser could not be forfeited by the receiver as "earnest".(31)

CONCLUSION

Invocation of liquidated damages clause should be taken recourse to by the employer only in such cases where there can be no two opinions that the contractor does not have the capacity to do the work- nor he will be able to complete the work within a reasonable time after the time stated in the contract expires. Any action taken in a hurry would land the employer in problem. Some amount of restraint in proceeding against the contractor must be exercised. The contractor may have genuine problems which he could not have foreseen with reasonable diligence at the time of entering into contract. If the employer takes into consideration the fact that it does not pay the contractor to delay execution of work, then he has to investigate as to why delay is occurring. The employer must endeavour to find solutions rather than saying that it is not his headache, since the aimed objective of the employer is to get the work completed rather than enter into any legal or financial complications.

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