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ANNUAL CONFERENCE OF THE INTERNATIONAL BAR ASSOCIATION



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Liquidated damages

Liquidated damages are an area of law that seems to mystify many legal scholars. In 1854, a New York Court of Appeals judge remarked that even the 'ablest judges have declared that they felt themselves embarrassed in ascertaining the principle on which the decisions... were founded.' This comment has remained strikingly valid. Simply stated, the courts continue to apply vague and confusing principles in the area of liquidated damages. Historically, this area of the law developed from equity, which granted relief against the harshness of penal bonds. A penal bond was a form of assurance whereby an individual would bind himself to pay a definite sum of money in the event he failed to perform another primary obligation. The equitable principle granting relief against such bonds later was adopted by courts of law and remains today as the foundation for the rule that penalties are void and unenforceable. However, courts later began to realise that, in certain situations where the actual damages could not be readily ascertained, promises to pay a stipulated sum in the event of a breach of contract were a valid alternative to the uncertainty of a jury's award. This distinction formed the basis for the differentiation between penalties and liquidated damages clauses.¹

Definition, meaning and concept

Generally, contracts that involve the exchange of money or the promise of performance have a liquidated damages stipulation. The purpose of this stipulation is to establish a predetermined sum that must be paid if a party fails to perform as promised.

Damages can be liquidated in a contract only if: (1) the injury is either 'uncertain' or 'difficult to quantify'; (2) the amount is reasonable and considers the actual or anticipated harm caused by the contract breach, the difficulty of proving the loss, and the difficulty of finding another, adequate remedy; and (3) the damages are structured to function as damages, not as a penalty. If these criteria are not met, a liquidated damages clause will be void.²

'Liquidated damages' means that it shall be taken as the sum that the parties have by the contract assessed as damages to be paid whatever may be the actual damage. The parties to the contract may agree at the time of contracting that, in the event of breach, the party in default should pay a stipulated sum of money to the other, or may agree that, in the event of breach by one party, any amount paid by them to the other shall be forfeited. It is a genuine 'pre-estimate of damages' likely to flow from the breach.³ 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. 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.⁴

Indian panorama

The principle of requiring payments to represent damages rather than penalties goes back to the equity courts, where its purpose was to protect parties from making unconscionable bargains or overreaching their boundaries. The Indian Contract Act 1872 provides a basic structure of the law of contract in India, its enforcement, various provisions regarding non-performance and the breach of contract. Sections 73 and 74 of the Indian Contract Act, 1872, are the relevant applicable laws.

Parties entering into a contract had to take safeguards to build in the relevant clause containing the applicable laws (that is, sections 73 and 74 of the Indian Contract Act 1872) by properly indicating the liquidated damages in the eventuality of breach/violation of the contract by either side, to ensure smooth conduct of the terms and conditions as contained in the agreement rather than approach a court of law at a subsequent date to determine a penalty for the breach or violation of any of the conditions contained in the agreement. Thus, in India, a stipulation to delay damages would act as an upper limit on the damages recoverable by the claimant for breach and the court has the discretion to reduce (but not increase beyond the amount stipulated in the contract) the damages; though the expression 'reasonable compensation' implies that this discretion is to be exercised with care.

The Supreme Court of India, in *Fabeh Chand v Bal Kishan Das*,⁵ called section 74 the provision cutting through the maze of rules evolved by English courts over a period of time to distinguish between what is considered a genuine pre-determination of damages and what is penalty and, therefore, not enforceable.

In *Masala Bux v Union of India A/c*,⁶ the Supreme Court repelled the contention that quantified amounts spelt out in a contract for supply of potatoes to the central government, were, in the circumstances of the case, genuine pre-determination of what the damages were likely to be and held that such conditions were unenforceable penalties. The court also noted that that the central government did not make any effort to establish the quantum of damage suffered by it.

Moreover, in the case of *Oil And Natural Gas Corporation Ltd v Saw Pipes Ltd*⁷ the court summarised that the terms of a contract must be taken into consideration if the

terms stipulating the liquidated damages in case of the breach of the contract are clear and unambiguous unless it is held that such estimate of damages/compensation is unreasonable or is by way of penalty. In every case of breach of contract, the person aggrieved by the breach is not required to prove actual loss or damage suffered by him before he can claim a decree. The court is competent to award reasonable compensation in case of breach even if no actual damage is proved to have been suffered in consequence of the breach of a contract. In some contracts, it would be impossible for the court to assess the compensation arising from breach and if the compensation contemplated is not by way of penalty or unreasonable, the court can award the same if it is genuine pre-estimate by the parties as the measure of reasonable compensation.

Universal attitude

Position in the United Kingdom

In recent years, liquidated damages clauses have attracted significant media coverage in the UK in relation to unfair bank and credit card charges. The reason for this has been the unwillingness of the English courts to enforce a liquidated damages clause if the sum stipulated to be paid upon breach is excessive or punitive – this could result in such a clause being regarded as a penalty clause and therefore unenforceable under English law.⁸

Position in France

French law treats penalty and liquidated damages clauses in a different manner. The amount contractually due under a penalty clause may be increased, or reduced, by the judge when it is 'obviously excessive or ridiculously low'. The judge may, by their own motion, decrease or increase the agreed penalty. In practice, judges rarely award a penalty which would be greater than five per cent of the contract price. The judge would determine the penalty awarded on the basis of the actual loss suffered. The enforceability of a liquidated damages clause depends on the nature of the damage that occurred. If it merits the legal qualification of 'decennial liability' damage, the liquidated damages clause would be deemed void. If this is not the case, it would be enforced, provided there is not a breach of an essential condition under the contract (*Chronopost* case), an intentional default or gross misconduct, or evidence of fraud.

Position in Spain

Articles 1152 and 1154 of the Spanish Civil Code, state that, in the event of breach of contract by delay, penalty shall replace contractual damages and payment of interest and the judge can modify the penalty in accordance with the performance of principal obligation. Therefore, contractual damages for delay are not just payments on account. However, the courts may adjust contractual damages.

Position in Jordan

Article 364 of the Civil Code states that upon an application by either party, the court can alter any fixed amount of liquidated damages for delay, in order to determine the actual damages suffered by that party.

Position in UAE

Article 390 of the Civil Code allows the contractor or the employer to vary the liquidated damages so as to fully reflect the actual loss. Further, the party seeking the alteration bears the burden of demonstrating the actual loss suffered and its variance from the liquidated damages as set out in the contract. As per Article 290, if the victim contributed to the damage or increased damage, the court may reduce the liability or award no damages.

Position in Germany

Under section 343 BGB of the German Civil Code, an unreasonably high penalty cannot be applied in case of delay, and the actual damages would be one of the factors to take into account for extent of such penalty. It depends on facts and circumstances of each case whether section 343 BGB can be applied by analogy to liquidated damages for delay.

Epilogue

Invocation of a liquidated damages clause should be taken by the employer as recourse only in such cases where there can be no two opinions that the contractor does not have the capacity to do the work – nor will he 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 trouble. 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 the 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 why a delay is occurring. The employer must endeavour to find solutions rather than saying that it is not his problem, since the aimed objective of the employer is to get the work completed rather than enter into any legal or financial complications.⁹

Liquidated damages clauses possess several contractual advantages too. First, they establish some predictability involving costs, so that parties can balance the cost of anticipated performance against the cost of a breach. In this way liquidated damages serve as a source of limited insurance for both parties. Secondly, the parties each have the opportunity to settle on a sum that is mutually agreeable, rather than leaving that decision up to the courts and adding the costs of time and legal fees.¹⁰

Therefore, the far-flung axioms laid down in the concept of liquidated damages can be said to be held steadfast when they come in the way of courts, ignoring the scepticism the concept has carried for a very long time. Liquidated damages and the hefty weight of monetary justice it carries, rests on the shoulders of each judge dealing with it and needs serious lucidity, as the provisions and its intrinsic principle are indispensable.

Notes

1. *Gothel v. Tolberg*, 9 N.Y.551, 553 (1854), [Calamart and J. Perillo, *The Law Of Contracts*, s 292 (1970).
2. See <http://legal-dictionary.thefreedictionary.com/Liquidated-damages>.
3. See www.legalserver.in/india.com/article/1250/liquidated-damages.html.
4. P.C. Markanda, 'Liquidated Damages - Applicability and Enforceability', (Indian Council of Arbitration), available at www.icaiindia.co.in/icamet/ipterli/jan-mar-2001/ica_jan2.htm.
5. *Push Chand v. Balkrishan Das*, AIR (1963) SC 1405.
6. *Moolji Bhai v. Union of India*, AIR (1970) SC 1955.
7. *ONGC v. Saw Pipe Ltd.*, AIR (2003) SC 2629.
8. See www.ateptoc.com/publications-6445.html.
9. *Ibid.*, n4.
10. See www.lawteacher.net/online-to-law/essays/liquidated-damages.php.