

# TIME OVER-RUNS....NOW WHAT???



## A. What is Liquidated Damages?

When Parties enter into a contract, sometimes the parties pre-estimate the damages that should be paid by the other party in case it defaults in performing its obligations under the agreement. This pre-estimated sum is known as liquidated damages. Black's law dictionary states the definition of liquidated damages as "The term is applicable when the amount of the damages has been ascertained by the judgment in the action, or when a specific sum of money has been expressly stipulated by the parties to a bond or other contract as the amount of damages to be recovered by either party for a breach of the agreement by the other"[1]

## B. Are liquidated damages provided under the Indian laws?

Yes, the concept of payment of stipulated sums or penalty for breach is covered under section 74 of the Contract Act, 1872 (Act) and the rule is that if a sum is named in the contract as the amount to be paid in case of breach, then the non-breaching party (provided it has suffered damages) shall be entitled to such sums or lesser amounts, as deemed fit by the court.

Section 74: Compensation for breach of contract where penalty is stipulated for: 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,

[1] The article reflects the general work of the author and the views expressed are personal. No reader should act on any statement contained herein without seeking detailed professional advice.

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or if the contract contains any other stipulation by way of penalty, the party complaining the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for.

This position of law is however distinct in different jurisdictions and parties should specifically incorporate the provision as per the applicable law chosen by the Parties. For example, the English Law makes a specific distinction between penalty and liquidated damages.

### C. Are the parties always entitled to all the sums named in the contract in case of breach?

No. The Act applies the uniform rule, that if the parties have stipulated a sum in the contract (whether the sum is construed to be a penalty or a pre-estimate of damages), the Court will award only reasonable compensation as deemed fit not exceeding the amount mentioned in the contract. Specifically, if the amount is found to be in the nature of penalty, then in such cases the Court shall reduce such stipulations but not strike it down completely (as done under the English law). This position is adopted as the parties are not supposed to be the adjudicatory authority and if the breach and injury is established, then the courts have the power to decide the breach and assess damages while the stipulated sum serves as the upper cap.

To understand this position better, an analysis is provided below:

Liquidated Damages	Penalty
This is a genuine pre-estimate of the damages which may be calculated basis various business factors specifically under the contract.	This is in the nature of <i>in terrorem</i> i.e. more in the nature of penalizing the other party rather than compensating the damages
If it's a genuine pre-estimation, then the court may enforce the calculation as it is.	Court may award only reasonable compensation and not the entire penalty as it deems fit.
<b>Illustration</b> A enters into a contract with B to undertake an interior design work for commercial space to be completed in 5 months, as B wants to start his office in that space. In case A defaults in completion of work and handover of office to B, the contract stipulates that A will pay the monthly rental of B. This stipulation is not by way of penalty, and the contract may be enforced according to its terms.	<b>Illustration</b> A enters into a contract with B for completion of a project, with a clause that in case A defaults and delays in completion of project, then B shall be entitled to recover triple the project costs from A. This is a stipulation by way of penalty, and B is only entitled to recover from A such compensation as the Court considers reasonable.

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## D. Pre-conditions for claiming Liquidated Damages

Before claiming Liquidated damages, parties claiming damages must check:

- (i) There is a valid contract existing between the parties.
- (ii) There is breach of contract causing some injury to the party.
- (iii) The party claiming damages has informed the defaulting party about breach of contract.
- (iv) Party claiming damages is not in fault.

## E. How are liquidated damages to be calculated?

The Hon'ble Apex Court in *Kailash Nath v. Delhi Development Authority*[3] laid down the guidelines for determining whether parties are entitled to 'liquidated damages or reasonable compensation'. For the sake of brevity the basic principles are summarised below:

- 1) Sum named in the contract is payable as the liquidated damages only if it is 'genuine pre-estimate of damages' otherwise the parties is entitled to only reasonable compensation not exceeding the fixed sum mentioned in the contract;
- 2) If any penalty is stipulated in the contract then only reasonable compensation is awarded not exceeding the amount so fixed for the penalty;

3) In case the court decides to award reasonable compensation, the basic principles of section 73 shall apply in assessment of compensation;

4) Proof of damage or loss is a sine qua non for grant of reasonable compensation under Section 74 and such proof is dispensed only if damages are difficult or impossible to prove and liquidated damages are genuine pre-estimate of damages.

Liquidated damages may be determined by the parties as per their specific business requirement. Parties may determine various ways to demonstrate estimation of damages as per their requirement.

Generally, liquidated damages are provided in the following manner:

1) For breach of certain obligations: Basis certain defined percentage of the value of the contract for each specific breach. The percentage can vary according to the industry standards and industry type, for instance Parties may specifically state that the defaulting party shall be required to pay liquidated damages at X% upto maximum of Y% of the value of the contract (to be determined by the parties) in case of breach of obligations mentioned in particular agreement.

2) For delay: each day of delay or week of delay to meet the targets may incur a specific amount i.e. the defaulting party shall be required to pay for each day or week of delay in adhering to the timelines mentioned above.

[2] CIVIL APPEAL NO. 193 OF 2015

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This may be defined according to the nature of the transaction, subject to the maximum limit of the damages.

## **F. What are the Advantages of having a liquidated damages clause in the contract.**

- Liquidated damages limit the amount of damages which is to be paid by the defaulting party to the aggrieved party to some extent.
- This clause enables the party to determine their risks and take appropriate business call based on the quantification of risks.
- The parties can conserve the time and costs involved in the litigations regarding the claim of damages.

## **G. What are the Disadvantages of having a liquidated damages clause in the contract.**

- Sometimes, the non-defaulting party may suffer a damage greater than the amount specified in the agreement and as per the provision of section 74, higher damages cannot be awarded. However, if the parties have negotiated on a detailed and overriding indemnity provision then the situation may be different as per the provisions of the contract.
- Further, as per the latest judgement of Supreme Court in Welspun Specialty Solutions Ltd. vs ONGC, if parties have defined liquidated damages for delay, then the clauses pertaining to time being of essence, cannot be enforced. More information on this specific aspect is available here.

## **H. Judicial review**

### **Welspun Speciality Solutions Limited Vs. Oil and Natural Gas Limited [3]**

Oil and Natural Gas Limited (ONGC) had floated a tender for delivery of metal pipes. Welspun Speciality Solutions Limited (Welspun) had won the tender. In the contract between the parties, the condition was laid down that time is of essence. During the course of the contract, there were certain delays in the delivery of the pipes. ONGC had waived the delays without invoking any liquidated damages clause. In one of the instances of delay, ONGC deducted amounts USD 8,07,804.03 and INR 1,05,367 as liquidated damages from the amounts payable to Welspun Speciality Solutions Limited. This invocation of liquidated damages was challenged before the arbitral tribunal. The Tribunal held that merely having a clause in the contract will not be enough, but there is other clause, which provides for extension of timelines, which is contradictory and would curtail the effects of the other clause. Thus, the arbitral tribunal held that pre estimated damages are not to be granted as there is no breach of contract, and actual damages may be computed.

ONGC claimed that tribunal had erred in grant of the unliquidated damages. Thus, it preferred an appeal to the District court and subsequently the High Court of Uttarakhand. The High court held that Arbitral Tribunal and District Court had erred in judgement, and that ONGC needn't prove the loss suffered before recovering damages.

[3] ((2022) 2 SCC 382)

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An appeal was preferred in the Hon'ble Supreme Court. ONGC also relied upon the ONGC Vs. Saw Pipes<sup>[4]</sup> judgement, in which liquidated damage was not granted, due to the fact that it was not stated that time is of essence.



Welspun contested that the view of the Arbitral Tribunal was reasonable and can be sustained. In the said contract, the time is not of essence, as there was provision for extension of timelines. The main question before the Supreme court was that liquidated damages are applicable and whether time was of essence of the contract. Arbitration award had concluded that time was not of essence, thus liquidated damages calculated by ONGC cannot be deemed appropriate.

The Supreme court held that the clause relating to the concept of time is of essence cannot be read in isolation but has to be understood in whole by reading the entire agreement.

In the case of ONGC Vs Saw Pipes (Supra), the extension of timeline was granted by ONGC subject to the recovery of the damages. But in the present case, ONGC has waived the damages twice before incurring the liquidated damages.

The Supreme court held that "The approach of the Arbitral Tribunal was to hold that once liquidated damages were waived in the first extension, subsequent extension could not be coupled with liquidated damages unless a clear intention flowed from the contract; while this Court recognizes the autonomy of the party to engage in contractual obligation. Such obligation must be contracted in clear terms. From the aforesaid discussion, it is clear that the promisee (ONGC) waived the liquidated damages initially and the same cannot be imposed, unless such imposition was clearly accepted by parties. In this case, the interpretation of the Arbitral Tribunal could not be faulted as being perverse. This Court cannot interfere with this award, as the award is a plausible view for the following reasons:

- a. The Arbitral Tribunal's interpretation of contractual clauses having extension procedure and imposition of liquidated damages, are good indicators that 'time was not the essence of the contract'.
- b. The Arbitral Tribunal's view to impose damages accrued on actual loss basis could be sustained in view of the waiver of liquidated damages and absence of precise language which allows for reimposition of liquidated damages. Such imposition is in line with the 2nd para of Section 55 of the Indian Contract Act.

[4] (2003) 5 SCC 705

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C. The Arbitral Tribunal was correct in distinguishing the dictum of this Court in Saw Pipes (supra), which validated imposition of liquidated damages in a similar contract.”

- **Conclusion:**

The Liquidated damages clause should be :

a) drafted precisely in the contract, so as to reflect the intention of the Parties.

b) a matter of considered choice and thought amongst the parties.

c) crafted in such a way that the damages that may be perceived should be a reasonable amount, and not be unreasonable.

It should also be noted that the clause is read together with the agreement and not read in a standalone manner and other overriding remedies in an agreement like indemnities may play a major role in ultimately determining a party's liability.

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