



CONTRACTS IN CONTEXT: UNDERSTANDING THE FINE LINE BETWEEN LIQUIDATED DAMAGES AND PENALTIES

CO-AUTHORED BY



Sonal Kumar Singh
Managing Partner



Ratik Sharma
Principal Associate



Parth Sindhwani
Associate

Contracts in Context: Understanding the Fine Line Between Liquidated Damages and Penalties

1. Introduction

The Indian Contract Act of 1872 includes provisions outlining the repercussions of a breach of contract between parties. Although the Act does not explicitly use the term liquidated damages, it uses the term ‘penalty’ in section 74. This raises the question of whether the terms ‘liquidated damages’ and ‘penalty’ are synonymous and interchangeable, or if there exists a subtle yet crucial distinction between the two.

Before understanding the fine line distinction between penalty and liquidated damages, it is pertinent to understand the distinction between the term “damage” and “damages”. Where the former is the loss or injury sustained by a party, the latter is actually the compensation given as a result of such damage. In summary, it can be said that ‘Damages’ pertain to the compensation that is either granted or pursued, whereas ‘damage’ denotes the harm or loss for which such compensation is requested or granted. ‘Damage’ is either financial or non-financial (such as loss of reputation, physical or mental distress), whereas ‘damages’ specifically relate to monetary compensation.

2. The Concept of Liquidated Damages

Section 74 of the Indian Contract Act, 1872 does not categorically specify and incorporate the term ‘Liquidated Damages’. For the sake of convenience, section 74 is reproduced herein below:

74. Compensation for breach of contract where penalty 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, or if the contract contains any other stipulation by way of penalty**, the party complaining of 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.*

The term Liquidated means “agreed or determined”. In the realm of contracts, Liquidated damages refer to the pre-agreed compensatory amounts agreed by parties at the time of entering into the contract. This clarity is evident in the language of the section i.e., **if a sum is named in the contract.** Consequently, claims arising from contractual clauses where the amount is predetermined and defined at the time when the contract was entered between the parties are referred to as Liquidated damages.

However, the essence of the liquidated damages lies in the wording used in section 74 of the Act i.e., **reasonable compensation not exceeding the amount so named.** The agreement stipulates a specific monetary amount that the aggrieved party can seek as compensation. Nevertheless, these monetary sums must be fair and should not exceed the predetermined amount specified in the contract as liquidated damages.

Hence, it is abundantly clear from the reading of the section itself that:

- Section 74 states “sum named in the contract as the amount to be paid in case of such breach”. So, whether this amount is deemed a penalty or falls under the category of liquidated damages, the result and the consequences remain unchanged.
- The section provides for a ‘reasonable compensation’ i.e., the ‘genuine pre-estimates’ which further implies that the amount stipulated must not be extravagant and unconscionable. The words “*whether or not actual damage or loss is proved to have been caused thereby*” indicate that even if there is no proof of actual damage or loss, the innocent party is still entitled to reasonable compensation in such circumstances. The stance was clarified in the case of ***Kailash Nath Associates v. Delhi Development Authority and Another***¹ wherein, it was held the “*expression “whether or not actual damage or loss is proved to have been caused thereby” means that where it is possible to prove actual damage or loss, such proof is not dispensed with. It is only in cases where damage or loss is difficult or impossible to prove that the liquidated amount named in the contract, if a genuine pre-estimate of damage or loss, can be awarded.*”

¹ 2015 SCC OnLine SC 19

- Lastly, the section makes it clear that the innocent party cannot receive compensation surpassing that particular amount or the penalty stipulated under the contract entered between them.

Another question that arises is whether the liability arises automatically in the event of a breach of the contract by one party. The question was answered in *Iron & Hardware (India) Co. v. Firm Shamlal & Brothers*² and *Indiabulls Properties P. Ltd. v. Treasure World Developers Pvt. Ltd*³ wherein it was observed that “*Therefore no pecuniary liability arises till the Court has determined that the party complaining of the breach is entitled to damages. Therefore when damages are assessed it would not be true to say that what the Court is doing is ascertaining a pecuniary liability which already existed. The Court in the first place must decide that the defendant is liable and then it proceeds to assess what that liability is. But till that determination there is no liability at all upon the defendant.*”

3. The Concept of Penalty

Apart from the stipulated sums of money provided under the contract at the time of initiation or inception of the contract, section 74 of the act also provides for “*...any other stipulation by way of penalty...*”.

The term ‘penalty’ though was absent in the original wording of the section and was subsequently introduced through an amendment in 1899⁴. In 1910, the Hon’ble Madras High Court⁵ observed that the amendment aimed to explicitly extend the provision’s applicability to any contractual stipulation designed to enforce performance, not solely limited to the payment of a specified sum in case of a breach.

In the Indian Context, the judgment of the Hon’ble Supreme Court of India in the matter of *Fateh Chand v. Balkishan Das*⁶, wherein a clause to forfeit the sums paid by the party was considered to be in nature of a penalty and it was observed that when a contract includes a provision for penalty, leading to the forfeiture of a deposited amount, the court is empowered

² 1954 SCC OnLine Bom 5

³ 2014 SCC OnLine Bom 4768

⁴ Amendment to Indian Contract Act, 1872. Act No. VI of 1899 passed by Governor General of India in Council.

⁵ Natesa Aiyar And Ors. vs Appavu Padayachi, (1910)20MLJ230

⁶ (1964) 1 SCR 515

to determine and award a reasonable sum, not surpassing and exceeding the specified forfeiture amount stated in the contract.

4. Whether proof of loss or actual damage is required to be shown by the Plaintiff to claim liquidated damages?

The established principle is that an individual who has not incurred any loss or damage cannot receive compensation, and Section 74 has not deviated from this notion. Even in case of ***Fateh Chand v. Balkishan Das***, the Hon'ble Court observed that “...the section 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”; **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.**”

In the matter of ***Pure Pharma Limited v. Union of India***⁷, while relying upon the decision passed in *Fateh Chand*, the Hon'ble High Court of Delhi observed that “*This is nothing but what was said in Fateh Chand (supra) that, while proof of actual loss or damages is dispensed with, there must be legal injury before compensation can be claimed*”

Most recently, in the matter of ***R.B. Enterprises v. Union of India***⁸, the Petitioner challenged the Arbitral Award on the grounds, *inter alia*, that Respondent failed to prove the damages claimed since no evidence was led by the Respondent. The Hon'ble High Court of Delhi in the instant matter set aside the arbitral award and held that “*It is thus apparent that no finding has been rendered by the learned Arbitrator that the Respondent suffered loss or damage on account of breach, which is a sine qua non of a claim of liquidated damage and instead has categorically noted that parties have not filed any document/evidence to prove the damage suffered.....There is no finding by the Arbitrator that the Respondent suffered any loss/damage and none was established by leading evidence. In fact, the admitted position is that parties led no evidence*

⁷ 2008 SCC OnLine Del 739

⁸ 2023 SCC OnLine Del 8321

and thus a mere reliance on the stipulation for pre-estimated damages and a finding of breach of contract cannot suffice in a claim of damages in light of the wealth of judicial precedents.”

Also, in the case of **Sudershan Kumar Bhayana (Deceased) Thr Lrs v. Vinod Seth (Deceased) Thr Lrs**⁹, the Hon’ble High Court of Delhi held that *“It is well settled that there are three essential ingredients that are required to be pleaded and established by a party claiming damages. First, that there is a breach of the Contract by the counterparty. Second, that the party complaining of such breach has suffered an injury as a result of the breach of the contract by the counterparty. And third, that the injury suffered is proximate and a direct result of the breach committed....Absent any pleadings that the owners had suffered damages or incurred loss on account of the delay in construction of the work, a claim of damages would not be sustainable.”*

Also, Hon’ble Delhi High Court In the matter of **Union of India and Another vs. Indian Agro Marketing Co-Operative Ltd.**¹⁰ has observed that *“It has been consistently held not only by this Court but even by the Apex Court that compensation can be given only for actual damages or loss suffered. Proof of actual damages or loss is a sine qua non for grant of damages under Section 74 of the Indian Contract Act unless it is pleaded that the damages are unquantifiable.”*

Hence, loss is a prerequisite for an award for damages and the party claiming such an amount as damages is required to show the occurrence of some legal injury.

5. The Fine Line Between Liquidated Damages and Penalty

The question which the present article aims to answer is whether the term “liquidated damages” and “penalty” can be used interchangeably and whether a subtle distinction lies between the two terms or not.

The answer to this question lies in the observations of Lord Dunedin in the matter of **Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd**¹¹ wherein the Hon’ble House of Lords held that:

⁹ 2023 SCC OnLine Del 6097

¹⁰ 2023 SCC OnLine Del 4621

¹¹ [1914] UKHL 1

- a. *“It will be held to be penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.”*

- b. It was further observed that *“It will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid”*.

The major contrast between liquidated damages and penalties is their purpose: liquidated damages attempt to recompense the non-breaching party for legitimate losses incurred, whereas penalties are intended to penalize the breaching party. Liquidated losses are a reasonable estimate of the real damages that the non-breaching party would face in the case of a breach, whereas fines frequently lack a clear link to the actual harm sustained by the non-breaching party.

The legal framework that governs liquidated damages and penalties is another important distinction. A fair assessment of the actual losses that will be sustained is required for liquidated damages, as they are subject to a reasonableness criterion. Conversely, penalties must meet a severe scrutiny test, meaning they must be reasonable and commensurate with the actual harm incurred.

In summary, Section 74 of the Indian Contract Act underscores the importance of reasonableness in both penalty and liquidated damages clauses. While liquidated damages are meant to compensate, penalties are subject to stricter scrutiny and should not be excessive or disproportionate to the actual loss suffered. Courts aim to strike a balance between enforcing contracts and preventing unjust enrichment or oppression through penal clauses.