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Liquidated Damages, Limitation & Arbitration: Examining their Interplay in Contractual Disputes

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ABSTRACT

This article delves into the relationship between liquidated damages, limitation, and arbitration in contractual disputes. It begins by explaining the concept of liquidated damages, highlighting their role in compensating parties for losses incurred due to contract breaches. Section 74 of the Indian Contract Act forms the legal basis for liquidated damages, distinguishing them from penalties. The article discusses relevant case laws, including judgments from the Supreme Court and various High Courts, to elucidate the criteria for categorizing liquidated damages and penalties. Furthermore, the article explores the dispensation of proof of actual loss in claims for liquidated damages, citing Section 74's provision and judicial precedents. It discusses scenarios, such as public utility contracts, where proof of loss may be impractical, thus necessitating compensation based on pre-estimated damages. Shifting focus to limitation periods in arbitration agreements, the article explores the application of Article 137 of the Limitation Act and the concept of the "breaking point" in determining the accrual of the cause of action. It attempts to highlight the significance of adhering to statutory limitations and the inability to extend these periods through negotiations or correspondence. In conclusion, this article attempts to provide a better understanding of the concept of liquidated damages and law governing it, at the same time, focussing on factors such as period of limitation which affect the claims for liquidated damages with special focus on arbitration agreements.

Keywords: *Liquidated Damages, Arbitration, Contract, Limitation.*

I. INTRODUCTION

Liquidated Damages are a contractual provision that specifies a pre-determined amount to be paid by one party to another in the event of a breach of contract in the nature of compensation, for the harm or loss incurred due to the breach. The fundamental principle behind the concept of liquidated damages is that parties to a contract agree to payment of a certain sum on the breach of contract in the nature of genuine pre-estimated/determined damages. Thus, when such

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stipulations are made in a contract, they are known as liquidated damages.

At the same time it is equally crucial for the parties to a contract to bear in mind that such damages must be reasonable and based on genuine estimate of potential loss. The Liquidated Damages which are in the form of genuine pre-estimated damages can be deducted in the event of breach caused by any of the parties. For instance, the clause for liquidated damages may stipulate a ceiling that may be a resultant of the delay in supply of deliverables. Generally and as a regular practice, the clause for Liquidated Damages is extensively negotiated, settled and mutually agreed between the parties so as to avoid any future disputes.

Furthermore, as a matter of practice, damages are to be awarded to recompense the aggrieved party. Meaning thereby, the party who has suffered a breach has to be placed as far as the money can do, in the same position in which it would have been if no breach had occurred at all so as to compensate the party who has suffered a breach.

This piece of article broadly covers the concept of Liquidated Damages as a bedrock for indemnifying a party that has suffered a loss on account of breach committed by the other party to the contract, in addition to the surrounding circumstances/factors such as period of limitation that influence the claim of a party towards Liquidated Damages in context of arbitration agreements.

II. LIQUIDATED DAMAGES UNDER THE INDIAN CONTRACT ACT, 1872

Section 74 of the Indian Contract Act deals with Liquidated Damages, i.e. damages that are stipulated for. For a reference, Section 74 is extracted hereunder:

*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.²*

As already highlighted above, damages are awarded to recompense or re-instate the aggrieved party which means that the party who has suffered a breach has to be placed in the same position in which it would have been if no breach had occurred at all. As a matter of fact, the damages

² Indian Contract Act, 1872, § 74

are meant to compensate the party who has suffered a breach.

(A) Liquidated Damages should not be treated as a Penalty

A bare reading of Section 74 of Indian Contract Act reveals that it provides for both liquidated damages and penalty. However, liquidated damages should not be considered as a penalty as it is a pre-assessed loss agreed between the parties at the time of entering into a contract as likely to arise from the breach of a contractual provisions or obligations, while penalties are usually disproportionate to the losses and higher than the losses that could result from the breach of contract, which are stipulated with the intent to ensure performance of the contract and to avoid any breach.

In this regard, the Hon'ble Apex Court in case of *BSNL v. Reliance Communication Ltd.*³ has observed that while the designation of a monetary sum payable upon breach of contract as either a 'penalty' or 'liquidated damages' is relevant, it is not the sole determining factor for categorization. The Court further referred to *Chitty on Contracts, 30th Edition*, to observe that that determining whether a contractual provision constitutes a penalty involves assessing its primary purpose at the time of contract formation: was it mainly intended to discourage breach or to fairly compensate for breach? Ultimately, the critical question is whether the clause genuinely estimates potential losses resulting from a breach.

The Hon'ble High Court of Madras in the case of *3i Infotech Limited Tower #5 v. Tamil Nadu E-Government Agency*⁴ also similarly observed that the main criterion for distinguishing between liquidated damages and penalty clauses is whether, at the time of contract formation, the specified amount reasonably correlates with the anticipated loss. If it does, it's considered a genuine pre-estimate of loss and treated as liquidated damages; if not, it's deemed a penalty clause.

(B) Whether Liquidated Damages can be Awarded Without Proof of Actual Loss

In actual fact, Liquidated Damages are pre-determined estimate of losses and corresponding compensation that are payable upon breach of contract and as such the need to prove the actual loss suffered by the aggrieved party may actually be dispensed with. Reliance in this regard can be placed on Section 74 of the Indian Contract Act that enables a person or a party to claim compensation despite not being able to prove the extent of loss or damage. By virtue of this, it is safe to say that Section 74 of the Indian Contract Act acts as a bulwark for the aggrieved party seeking a compensation as a consequence of breach, entitling it to claim compensation

³ BSNL v. Reliance Communication Ltd., MANU/SC/1000/2010

⁴ 3i Infotech Limited Tower #5 v. Tamil Nadu e-Government Agency and Ors., MANU/TN/9245/2019

regardless of whether it has been able to prove the extent of loss/damage suffered by them.

For example, in a public utility contract, the factum of loss is assumed as a result of breach and is deemed impossible or at the most difficult to prove. As such, in case of a breach of a public utility contract, the state entity is guaranteed to be awarded compensation either the entire stipulated amount in the Contract if deemed to be a genuine pre-estimate of loss or an amount considered reasonable by the court.

The Hon'ble Apex Court in the case of *Construction and Design Services v. Delhi Development Authority*⁵ awarded half the amount stipulated under the Contract as reasonable compensation, basing its relief entirely on the public utility argument for liquidated damages. Since the clause in the Contract provided for an upper limit of compensation and did not provide a fixed sum, the Court held that in the absence of evidence of loss, part of it can be held as reasonable compensation and the burden to prove that no loss was suffered because of the delay was on the contractor.

Be that as it may, if the aggrieved party has been able to calculate the loss suffered by them owing to the breach committed by the other party, then the party that has suffered losses ought to be awarded Liquidated Damages which is in the same vein as a compensation. In this regard the Hon'ble High Court of Madras in the matter of *3i Infotech Limited Tower #5 (supra)* further observed that:

“Given the fact that a party claiming liquidated damages cannot claim more than the stipulated sum, once such party establishes that the stipulated compensation is a genuine pre-estimate, a high standard of proof would not be insisted upon to prove difficulty or impossibility of proving loss.

..... On the contrary, if it is concluded that the stipulation is by way of penalty, the person claiming such penalty would be required to prove loss accurately, including the quantum of loss, and claim reasonable compensation on that basis.”

Furthermore, the Courts have time and again held that though as per Section 74, aggrieved party can be awarded liquidated damages even in absence of proof of actual loss or damage, but the party claiming such damages must show that some loss has been suffered by him due to breach of contract. Therefore, liquidated damages can generally be not granted where no loss is

⁵ Construction and Design Services v. Delhi Development Authority, MANU/SC/0099/2015

suffered. The Hon'ble High Court of Delhi explained this proposition in case of **Indian Oil Corporation v. Lloyds Steel Industries Ltd.**⁶ and held, in a nutshell, that compensation should only be awarded when actual loss or damage is suffered, however, if proving the exact extent of the loss is challenging due to complex circumstances, Section 74 allows for compensation as long as it's established that some loss or damage occurred. Thus, while proof of the exact extent of loss isn't required, demonstrating that loss or damage has indeed transpired remains essential for claiming compensation.

While summarizing the law of Section 74 of Indian Contract Act, the Hon'ble Apex Court in case of **Kailash Nath Associates v. DDA**⁷ had also clarified the position *qua* requirement of loss of damage suffered pursuant to breach, and proof of actual loss or damage. The relevant observations are as under:

“43.3. Since Section 74 awards reasonable compensation for damage or loss caused by a breach of contract, damage or loss caused is a sine qua non for the applicability of the Section...”

43.6 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.”

III. LIMITATION AS A FACTOR AFFECTING CLAIM TOWARDS LIQUIDATED DAMAGES IN CASES OF ARBITRATION AGREEMENTS

As a general rule, the limitation period for filing of suits relating to contracts, including a suit for seeking compensation for breach of contract, is three years as per Part-II of Schedule to Limitation Act, 1963. This period commences as soon as the contract is broken or breached.

However, in cases where the parties choose to govern themselves through an arbitration clause for the purpose of resolution of their disputes including one related to payment of liquidated damages, the limitation period for issuing notice invoking arbitration would be governed by the residuary article i.e. Article 137 of the Schedule to Limitation Act. As per Article 137, the period of limitation is three years and the said period would begin to run *when the right to sue first*

⁶ Indian Oil Corporation v. Lloyds Steel Industries Ltd., MANU/DE/8665/2007

⁷ Kailash Nath Associates v. DDA, MANU/SC/0019/2015

accrues.

It was held in case of *Geo Miller and Co. Private Limited v. Chairman, Rajasthan Vidyut Utpadan Nigam Limited*⁸ that the Courts have to find out as to what was the “breaking point”, which would be treated as the date on which cause of action arises for initiating arbitration proceedings, for the purpose of limitation. The Breaking point of an arbitration occurs at a time at which any reasonable party abandons efforts at arriving at a settlement, i.e. the date on which the cause of action arises for the purpose of limitation.

The legislature has prescribed a period of three years for the enforcement of claim and Section 9 of the Limitation Act also provides that once time has begun to run, no subsequent disability or inability to institute legal proceedings stops it. In other words, a claim can be brought within a period of 3 years from the date when the right to sue first accrues, as per Article 137 which applies in cases of seeking appointment of Arbitral Tribunal, and no subsequent disability or inability to institute a suit or bring any claim can stop it.

It is also a settled legal principle that this statutory period cannot be circumvented merely on the ground that the parties were involved in a ‘negotiation’. Mere negotiations in an anticipation of some amicable settlement cannot save the period of limitation as time already starts running from the date when the cause of action has accrued. Reliance in this regard can be placed on the judgment of the Hon’ble Apex Court, i.e. *B and T AG v. Ministry of Defence*⁹ wherein this proposition of law was affirmed and it was held that the period of limitation, for seeking appointment of arbitrator, being aggrieved by deduction of liquidated damages, is three years and the period would run when the right to sue accrues. It is also settled that any “bilateral discussions” for an indefinite period of time would not save the the situation so far as the accrual of cause of action and the right to apply for appointment of arbitrator is concerned.

Even otherwise, mere correspondence exchanged between the parties will not enlarge or extend the period of limitation for raising any claims and the accrual of cause of action cannot be postponed merely by writing letters/sending emails or reminders to the respondent pursuant to accrual of a cause of action, and as such in any manner extend the period of limitation. In this regard, decision in case of *Geo Miller and Co. Private Limited (supra)* by the Hon’ble Apex Court can be taken note of, in which it was held that mere exchange of letters/emails by no stretch of imagination can extend the period of limitation in respect of a time-barred claim such as the one that is raised at a much belated stage, that is after the prescribed period of limitation

⁸ Geo Miller and Co. Private Limited v. Chairman, Rajasthan Vidyut Utpadan Nigam Limited, MANU/SC/1198/2019

⁹ B and T AG v. Ministry of Defence, MANU/SC/0601/2023

of 3 years from the date when the cause of action first arises.

It is therefore clear that the right to apply would accrue when differences between the parties to the arbitration agreement are evident, that is when the parties reach a “breaking point” which means when a settlement with or without conciliation is no longer possible.

IV. CONCLUSION

The inquiry encompassing the idea of liquidated damages in an agreement should be deeply evaluated to ascertain whether it is a penalty or genuinely deals with the pre-estimated loss arrived due to breach of contract. As long as liquidated damage serves a compensatory purpose and there is a genuine loss, the Court should grant damages to the aggrieved party without the need to measure or prove the definite/actual loss.

Other factors including but not limited to whether the claim of a party towards liquidated damages is within the period of limitation is also a pivotal aspect that has to be given due consideration as a claim that suffers from delay and latches deserves to be dismissed at the very outset, ensuring fair resolution for both parties in contractual disputes.
