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DAMAGES- A LEGAL AND INDUSTRY PERSPECTIVE

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Abstract

The purpose of this article is to give an in-depth analysis of the concept of damages. Further, an attempt is made to give a hawk-eye view of the types of damages that are considered in the present-day scenario. A special emphasis is given on the issue of Liquidated Damages and an analysis viz-a-viz the construction industry is drawn. Relevant case laws of various courts have been cited thereby explaining the evolution of the jurisdiction of damages from a contractual perspective.

Design/methodology/approach

A detailed research study has been conducted referring to various legal statutes and commentaries of noted jurists. Further, landmark judgments of the Hon'ble Supreme Court and various High Courts have been looked at and the findings of various courts have been duly referred to in the article. Personal meetings and interviews with doyens from the construction industry have been conducted to understand their inference of damages as a concept and its implications in day-to-day business.

Originality/value – The article has been crafted after the due application of domain knowledge. While multiple authorities have been referred to, the same has been duly documented and cited for reference. An effort is made to carve out a document of the author's understanding of the concept of damages.

Keywords: Damages, Contract, Liquidated, Penalty, Construction

Paper type: Research Article

Introduction

Damages refer to a form of compensation due to a breach, loss or injury[1]. As explained by Fuller and Perdue, damages may seek the protection of 'expectation interest', 'reliance interest' or 'restitution interest'. Expectation interest (otherwise known as performance interest) refers to placing the plaintiff in a position that he would have occupied, had the defendant performed his promise by compensating for the injury, thus, aiming at fulfilling the expectation of the promisee[2]; reliance interest (otherwise known as status quo interest) refers to a restoring the plaintiff to a position which he was in before the promise was made in the course of which the promise altered his position by placing reliance on the promisor[3]; and restitution interest refers to

[1] Common Cause v. Union of India (1999) 6 SCC 667.
[2] AT Brij Paul Singh & Bros. v. State of Gujarat AIR 1984 SC 1703; MSK Projects (I) (JV) Ltd. v. State of Rajasthan (2011) 10 SCC 573
[3] Kanchan Udyog v. United Spirits Limited (2017) 8 SCC 237.

prevention of gain by the defaulting promisor at the expense of the promisee or to compel the defendant to pay for the values received from the plaintiff thereby preventing unjust enrichment.[4]

'Damages' are often confused with 'damage'. However, these two terms are significantly distinct. While 'damages' refer to the compensation awarded or sought for, 'damage' refers to the injury or loss which such compensation is claimed for or being awarded. 'Damage' could be monetary or non-monetary (loss of reputation, physical or mental pain or suffering) while 'damages' refer to pecuniary compensation.

Damages can also be distinguished from compensation, in general. Compensation is a broader concept that encompasses payments made to a person in respect of some kind of loss or damage suffered due to reasons like acquisition of property by another party, statutory violations, termination of employment, requiring the aggrieved party to be compensated; however, damages emanate from actionable wrongs[5]. In common parlance, compensation is often used to refer to damages as well. Moreover, the Indian Contract Act 1872 ("Contract Act"), refers to the term 'compensation' in the context of liquidated and unliquidated damages.

Damages have gained much significance, especially among commercial transactions, and as punitive measures for violation of rights of concerned persons. The nature of damages granted across various areas varies significantly, for example in cases relating to indemnity contracts.

Indemnity is a kind of protection from third-party losses, which is ensured by an indemnity agreement between the claimant (indemnified) and the indemnifier. A claim for indemnity arises from the original contract of indemnity while a claim for damages arises on breach of a contract. Unlike damages under ordinary contracts where the defendant has the primary liability to pay the damages, under indemnity contracts, the risk of future losses and liability to pay damages shifts to the indemnifier.

Damages are popularly granted in cases of tort or breach of contract. While there are damages of multiple sorts, this article broadly covers liquidated damages in cases of contractual breaches in India with special emphasis on engineering, procurement and construction contracts (also known as EPC contracts).

However, a generic listing of the broad spectrum under which damages are levied is listed below.
The nature of damages used or sought depends on the objective for which damages are being claimed. Thus, damages can be categorized into one or more of the following kinds:

Types of Damages:

I. General and special damages

Damages that arise in the normal course of events are known as general damages while special damages refer to those that arise under circumstances that were reasonably anticipated by the parties when they entered into the contract. Once damage is proven, general damages are presumed to follow such damage, while specific proof of such damage is necessary to be established in case of a claim for special damages.

II. Nominal damages

Nominal damages may be awarded even when there is no actual loss or injury caused to a party against whom a breach has been caused, or in cases where there has been a violation of a legal right, without any actual damage being proved. Thus, in case a party fails to prove actual loss resulting from a breach of contract, nominal damages may be granted.[6] Nominal damages may also be granted where a party is proven to have suffered damages as a direct consequence of the breach of contract but it is difficult to calculate the same with mathematical accuracy. Nominal damages may also be awarded where a technical breach of contract has been committed or when the losses have been incurred due to a reason that is not attributable to the defendant.[7]

[4] L.L. Fuller and Willian R. Perdue Jr., 'The Reliance Interest in Contract Damages' (1936) 46 Yale Law Journal 52
[5] Halsbury's Laws of England, Damages, vol 12 (4th edn) para 815 as cited in R.G Padia (ed.), Pollock and Mulla Indian Contract and Specific Relief Acts, vol 2 (13th edn, LexisNexis Butterworths Wadhwa 2006) 1498.
[6] Chaudhary Construction Co. v. Delhi Development Authority (1998) 1 Arb LR 334; Bismi Abdullah & Sons v. Regional Manager of FCI AIR 1987 Ker 56.
[7] See, Vikas Electrical Service Pann Bazar Hubli v. Karnataka Electricity Board, AIR 2008 Kar 88..

III. Substantial damages

Substantial damages are awarded when the extent of the breach of the contract is proved but there are uncertainties regarding the calculation of damages.

IV. Speculative damages

Speculative damages are those, which are allowed when the probability that a circumstance will exist as an element for compensation becomes conjectural.[8] Broadly, there may be two kinds of circumstances in this regard:

- when the damages are uncertain or contingent, i.e., not the certain result of the breach
- those where the damages are uncertain in amount.

Uncertain damages, which are not the certain result of a breach or a wrong, are not recoverable. However, damages that are attributable to the wrong and only uncertain in respect of their amount may be recovered. In such a case, while the damages may not be determined by mere speculation or guess, it will be enough if the evidence shows the extent of the damages as a matter of just and reasonable inference, although the result be only approximate. However, courts in India are generally reserved while granting speculative damages.

V. Aggravated and exemplary damages

These damages are of such nature that they exceed the damages ascertained, mostly resulting from the mala fide conduct of the defendant.[9] Aggravated damages gain significance where the damage caused to the plaintiff is aggravated due to the motive, conduct or manner of inflicting injury, whereby the plaintiff's feelings and dignity are adversely affected resulting in mental distress. Aggravated damages are mostly compensatory since they aim at compensating the plaintiff for the aggravated loss suffered. On the other hand, exemplary damages are punitive in nature since they intend to punish the defendant and not merely compensate or deprive the defendant of the profits made.

Since damages under contractual breaches do not consider the motive and conduct of defendants, aggravated and exemplary damages are more prominent in torts and not under contractual breaches.[10] This is primarily because the objective behind contractual remedies is to compensate the promisee for the breach rather than compelling performance on the promisor. However, where elements of fraud, oppression, malice etc. are established, exemplary damages may be granted, which may not be confined to compensation proportionate to pecuniary losses suffered by the injured person.

VI. Liquidated and unliquidated damages

Parties may agree to payment of a certain sum on breach of the contract. When such stipulations are made in the contract, they are known as liquidated damages. On the other hand, unliquidated damages are awarded by the courts on an assessment of the loss or injury caused to the party suffering such breach of contract[11]. Parties may provide for liquidated damages for certain kinds of breaches, while other kinds of breaches may be compensated by way of unliquidated damages. For instance, a liquidated damages clause may stipulate a

[8] Justice SS Subramani and VR Manohar (eds.), P Ramanatha Aiyar The Major Law Lexicon, vol 6, (4th edn, 2010) 6401.
[9] Koninlijke Philips NV v. Amazestore (2019) 260 DLT 135; Inter Ikea Systems v. Sham Murari 2018 SCC OnLine Del 11221.
[10] The common law approach has been that aggravated damages cannot be awarded in an action for breach of contract. See, Addis v. Gramaphone Co. Ltd. (1909) AC 488; Bliss v. SE Thames Regional Health Authority (1987) ICR 700; Ghaziabad Development Authority v. Union of India & Another (2000) 6 SCC
[11] Steel Authority of India Ltd. v. Gupta Brother Steel Tubes Ltd. (2009) 10 SCC 63

ceiling on account of delay in delivery; however, such a clause would not prevent a party from claiming damages on account of the goods supplied under the contract being defective.[12]

VII. Differentiating liquidated damages from penalty

While liquidated damages are pre-determined estimates of losses and corresponding compensation, that is payable on breach of the contract, 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.

The stipulation made within the contractual terms is often disputed as to whether such stipulation is like a penalty or liquidated damages. Differentiating between 'penalty' and 'liquidated damages', the Supreme

Court has been of the view that:

"whether a provision is to be treated as a penalty is a matter of construction to be resolved by asking whether at the time the contract was entered into the predominant contractual function of the provision was to deter a party from breaking the contract or to compensate the innocent party for breach. The question to be always asked is whether the alleged penalty clause can pass muster as a genuine pre-estimate of loss.[13]

In this regard, the Madras High Court had observed as below:

"The primary test for identifying and distinguishing between liquidated damages and penalty clauses is whether, when tested as of contract formation, the stipulated sum bears a reasonable correlation to anticipated loss; if so, it would be construed as a liquidated damages clause and, if not, as a penalty clause. A stipulated sum that bears such reasonable correlation to anticipated loss is considered as a genuine pre-estimate of loss."[14]

Regarding the enforceability and tests for liquidated damages claims and penalty clauses, the Madras High Court had 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. In other words, the court would bear in mind that parties negotiated and concluded the contract based on risk allocation, whereby the party claiming liquidated damages forecloses the possibility of claiming an amount higher than the sum stipulated, by way of proving higher actual loss, to enjoy the benefit of the relative ease and certainty of establishing a claim for liquidated damages as opposed to a claim for unliquidated damages. 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."

With respect to the nature of liquidated damages under the Contract Act, the Supreme Court has observed that:

"Duty not to enforce the penalty clause but only to award reasonable compensation is statutorily imposed upon courts by Section 74… In all cases…where there is a stipulation in the nature of a penalty for forfeiture of an amount deposited under the terms of contract which expressly provides for forfeiture, the court has jurisdiction to award such sum only as it considers reasonable but not exceeding the amount specified in the contract as liable to forfeiture."

Section 74 of the Contract Act refers to a 'stipulation by way of penalty'. Accordingly, it applies where a sum is named as a penalty to be paid in the future in case of breach, and not to cases where a sum is already paid and liable to forfeiture by a covenant in the contract.

[12] Oil & Natural Gas Corporation Limited v. Soconord 2014 SCC OnLine Bom 1277.
[13] BSNL v. Reliance Communication Ltd., (2011) 1 SCC 394
[14] M/s 3I Infotech Limited v. Tamil Nadu E-Government Agency, 2019 SCC Online Mad 33295.

Forfeiture of a reasonable amount paid as earnest money or advance deposit as part payment may not amount to the imposition of penalty; however, in cases where the forfeiture is like a penalty, Section 74 applies. Earnest money is part of the purchase price when the transaction goes forward, and would be required to be forfeited on occasions of failure of transactions which could be due to the fault or failure of the vendee.[15] However, in cases where a party has 'undertaken' to pay a sum of money or to forfeit a sum of money which he has already paid to the party complaining of a breach of contract, the undertaking may be considered to be like a penalty.[16]

Further, to forfeit the sum deposited by the contracting party as "earnest money" or "security" for the due performance of the contract, it is necessary that the contract must contain a stipulation of forfeiture.[17] A right to forfeit being a contractual right and penal in nature, the parties to a contract must agree to stipulate a term in the contract on that behalf, a fortiori, if there is no stipulation in the contract of forfeiture, there is no such right available to the party to forfeit the sum.

Damages under cases relating to Engineering, Procurement and Construction contracts

In India, construction contracts are usually based on the Engineering, Procurement and Construction model ("EPC"). These are turnkey contracts in which the responsibility of designing, procurement of material and construction gets transferred from the owner to the contractor.

The time and cost risks thereby shift to the contractor. Generally speaking, construction contracts involve high costs and stakes, therefore, delay or breach can have substantial repercussions for the parties. Calculation of damages for underperformance, delay or non-performance are of critical importance in construction disputes. Usually, claims made in construction disputes are for damages due to loss of profits, delay, disruption, loss of opportunity, underperformance or non-performance.[18]

In McDermott International Inc. v. Burn Standard Co. Ltd[19]., the Hon'ble Supreme Court has analyzed various issues regarding the computation of damages, and considered certain formulae which are followed to compute damages in construction disputes globally, as produced below:

i. Hudson Formula is stated in the following terms: "Contract head office overhead and profit percentage × (Contract sum ÷ Contract period) × Period of delay"

In the Hudson Formula, the head office overhead percentage is taken from the contract.

Although the Hudson Formula has received judicial support in many cases, it has been criticised principally because it adopts the head office overhead percentage from the contract as the factor for calculating the costs, and this may bear little or no relation to the actual head office costs of the contractor.

ii. The Emden Formula is stated in the following terms

"Head office overhead and profit percentage × (Contract sum ÷ Contract period) × Period of delay" This formula has the advantage of using the contractor's actual head office overhead and profit percentage rather than those contained in the contract. This formula has been widely applied and has received judicial support.

iii. The Eichleay Formula is stated in the following terms

Step 1- (Contract billings ÷ Total billings for contract period) × Total overhead for contract period =Overhead allocable to the contract

[15] Kunwar Chiranjit Singh v. Har Swarup AIR 1926 PC 1; see Shree Hanuman Cotton Mills and Anr. v. Tata Aircraft Limited, 1970 (3) SCR 127

[16] Maula Bux v. Union of India (1969) 2 SCC 554.

[17] Suresh Kumar Wadhwa v. State of M.P., 2017 (16) SC C 757.

[18] . John A Trenor, The Guide to damages in International Arbitration, (2nd ed., Law Business Research Ltd, 2017).

[19] (2006) 11 SCC 181.

Step 2- Allocable overhead ÷ Total days of contract= Daily overhead rate

Step 3- Daily contract overhead rate × Number of days of delay= Amount of unabsorbed overhead"

This formula is used where it is not possible to prove loss of opportunity and the claim is based on actual cost. The total head office overhead during the contract period is first determined by comparing the value of work carried out in the contract period for the project with the value of work carried out by the contractor as a whole for the contract period. A share of head office overheads for the contractor is allocated in the same ratio and expressed as a lump sum to the particular contract. The amount of head office overhead allocated to the particular contract is then expressed as a weekly amount by dividing it by the contract period. The period of delay is then multiplied by the weekly amount to give the total sum claimed. The Eichleay Formula is regarded by the Federal Circuit Courts of America as the exclusive means for compensating a contractor for overhead expenses.

Since the computation of damage would depend on circumstances and the method of computation, arbitral tribunals may exercise their discretion in adopting the formula for computation unless provided for in the underlying contract.[20]

Further, in arbitrations relating to construction disputes, it is common practice for parties and arbitrators to rely upon expert valuations, expert reports and expert witnesses. This emanates from the complex nature of such disputes and the granular details that can be best analyzed by industry experts. It is pertinent to note that liability for breaches in construction contracts is determined on a case-by-case approach. It is attributed to the party who is responsible for the delay or underperformance resulting in a breach of the contract. Delays in the completion of construction cannot always be attributed to the contractor. It is settled law that when the delay is due to acts of the employer, he cannot be exonerated of his responsibility to pay damages by granting an extension of time unless the employer establishes that the contractor has consented to accept the extension of time alone, in satisfaction of his claims for the delay. Further, if the contract specifically limits liability to certain events or excludes claims for some kind of damages, the court or tribunal would not transcend beyond the terms of the contract to award damages beyond the scope of what the parties have agreed to. To succeed in a claim for damages due to delay in construction, the party claiming it needs to establish that 'time was of the essence' in the contract. Time is not always of the essence in a construction contract, unless specifically mentioned or specific features exist thereof.

Contracts which include a pre-determined Mechanism in the Event of any Breach

In some contracts, at the time of execution, the parties agree to an amount of compensation payable in the event there is any breach of the contract, by way of liquidated damages. The Black's Law Dictionary[21] defines a liquidated damages clause as "a contractual provision that determines in advance the measure of damages if a party breaches the agreement". In such cases, where the amount payable in the event of breach of contract is pre-determined, the Court may award any sum of money which is reasonable, but not exceeding the amount agreed to between the parties. The question which therefore begs consideration is what quantum should be specified in the liquidated damages clause and whether the entire amount stipulated in the liquidated damages clause may be awarded in case of breach.

The Supreme Court has considered this substantially in Kailash Nath Associates v. Delhi Development Authority[22] wherein it was observed that the party complaining of the breach can receive the entire amount stipulated in the liquidated damages clause only if it is a genuine pre-estimate of damages suffered. While assessing the quantum of damages suffered, the Court has jurisdiction to award amounts as it deems reasonable but not exceeding the limit stipulated in the contract. The Court went on to observe that while Courts have the jurisdiction to grant reasonable compensation, the liquidated damages as stipulated in the contract would be the upper limit and the Court cannot award any compensation beyond that upper limit.

[20] McDermott International Inc. v. Burn Standard Co. Ltd (2006) 11 SCC 181

[21] Seventh Edition (1999).

[22] (2015) 4 SCC 136.

The Supreme Court's view in Kailash Nath (supra) appears to suggest that even in situations where the contracting parties have bargained for a reasonable pre-estimate as a measure of damages (i.e. liquidated damages) the party alleging breach is still required to satisfy the adjudicator of the loss suffered and possibly to some extent the quantum of it. Is this a departure from trends established earlier. In the not-so-distant past, the Supreme Court held that in contracts containing a liquidated damages clause, it would be difficult to prove the exact loss or damage that the parties suffer because of the breach thereof. In such a situation, if the parties have pre-estimated such loss after clear understanding, it would be unjustified to conclude that party who has committed a breach of the contract is not liable to pay compensation. It would be against the specific provisions of Sections 73 and 74 of the Indian Contract Act.