

# Threshold for damages payable

Why it's time to emulate English courts, which have moved closer to minimising judicial interference in commercial contracts



**Rule at work** A 'liquidated damages' clause in engineering and construction agreements aims to ensure timely completion ISTOCK.COM

**VASANTH RAJASEKARAN**  
**SAURABH BABULKAR**  
**HARSHVARDHAN KORADA**

**L**iquidated damages (LD) have been an important parameter of negotiations in businesses where timeline is the key. An LD clause in a contract stipulates the money payable as damages for loss caused due to breach of contract (for example, delays) irrespective of the actual loss suffered.

LD clauses are a regular feature of engineering and construction agreements, where the parties agree over the damages payable for a delay of each unit of time (typically a day or a week) beyond the contractual date of completion. The UK Supreme Court, in a recent decision in *Triple Point Technology, Inc vs PTT Public Company*, discussed the benefits of a pre-determined threshold of damages under an LD clause.

First, through an LD clause, parties can avoid the hassle of quantifying losses on breach of contract. Second, the parties can effectively manage the commercial risk of the contracts executed by them. LD clauses also crystallise the maximum risk, rather than leaving it open-ended. Lastly, the parties are incentivised to complete on time.

## 'Genuine pre-estimate' test

When drafting LD clauses, it is important to determine an appropriate threshold for damages. For instance, in English law, if the amount stipulated in an LD clause is held to be in the nature of a penalty, then the clause would be held void and unenforceable.

The test to determine what constitutes a penalty has changed from time to time. The foundations of the English law on LD are found in the 1915 case of *Dunlop Pneumatic Tyre vs New Garage & Motor Co*, where it was held that an LD clause should set out a 'genuine pre-

estimate of damages' to be enforceable. A similar position was held by the Supreme Court of India in *Maula Bux vs Union of India*, where ascertaining a reasonable compensation under LD entailed determining whether it was a genuine pre-estimate of damages. The standard for genuine pre-estimate of damages was adopted by the Supreme Court more recently in the *Kailash Nath vs Delhi Development Authority* case.

In 2015, the UK Supreme Court reviewed the English law on LD in *Cavendish Square Holding BV vs Makdessi*. It retained the principle that if an LD clause was like a penalty, then it ought to be struck down. However, it also said that the distinction between a "genuine pre-estimate" of losses and "penalty" was never clear and was more in the nature of "artificial categorisation". Thus, what may not be a genuine pre-estimate may also not be a penalty, and therefore may not be struck down. The true test, as per *Cavendish*, lay in checking whether the LD was proportional to secure the legitimate interest of an innocent party aggrieved by breach of contract.

In another English decision in *Eco World-Ballymore Embassy Gardens Company Limited vs Dobler UK*, it was held that while determining whether an LD clause provided for a penalty, the court would ascertain the intent of the parties from the perspective of reasonableness — only if the amounts provided under the LD clause were "unconscionable or extravagant" would it be struck off as a penalty.

The English law has gradually drifted away from the stricter threshold of genuine pre-estimates to a more holistic assessment of whether the quantum of LD would amount to an unconscionable obligation on the party in breach. With the decision in *Cavendish* in place, the

UK courts would begin with the presumption that the parties entered into the bargain with common consensus and hence be reluctant to strike off the LD clause. The presumption would be stronger in situations where it is understood that the parties in the commercial negotiations had the benefit of appropriate expert aid and advice.

## Post-Cavendish trends in India

Many Indian courts refer to the *Cavendish* decision in LD cases. For instance, in *Electronics Corporation of Tamil Nadu vs ICMC*, the High Court of Madras referred to the decisions in *Dunlop Tyre* and *Cavendish*. The High Court decision appears to have adopted the proportionality standard set in *Cavendish* in a passing reference while holding that there was proportionality in the extent of delay and the quantum of liquidated damages sought.

However, Indian courts broadly rely on the principle of "genuine pre-estimate" of losses. Thus, while the English courts have moved a step closer to minimising judicial interference in commercial contracts and favoured party autonomy, Indian courts have been careful in raising the bar of genuine pre-estimate of losses and reasonable compensation. This may have something to do with the economic and commercial ecosystems of the two jurisdictions.

However, as more and more foreign and institutional investors walk into the country and the Indian start-up ecosystem flourishes, there would be a need to adopt a threshold similar to the one laid in *Cavendish*, which appears to be a more practical and mature approach towards determining liquidated damages.

*The writers are advocates at Trinity Chambers, Delhi*