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Legitimate Interest test and Party Autonomy: Correcting the discourse on Liquidated Damages within the Indian Contract Act 1872

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Abstract

The Indian Contract Act 1872 (the Act) is largely a codification of the principles, fundamental to the English Contract law. Accordingly, party autonomy is securely entrenched amongst the various provisions of the Act. The provision on liquidated damages too continue to retain the spirit of party autonomy. Unfortunately, the Indian Courts have misread the provision on liquidated damages and ignore the theoretical underpinnings on party autonomy. Consequently, the discourse on liquidated damages is in disarray. In contrast the English Contract Law has witnessed tectonic shifts in the theoretical terrain on liquidated damages. The legitimate interest test, as developed by the UK Supreme Court (UKSC), has forced a re-think on the issue of liquidated damages. Importantly the legitimate interest test reinforces the role of party autonomy in ascertaining the validity of the clause on pre-determined damages. This article argues that the Act is no stranger to the legitimate interest test. The provision on liquidated damages is proof of the same. The article concludes that the time has come for the Indian Courts to unapologetically adapt the legitimate interest test and promote party autonomy. For such adaptation will bring about the much needed course correction in the narrative on liquidated damages.

Keywords- *Party Autonomy, Legitimate Interest, Indian Contract Act, 1872, English Contract Law*

I. Rooting for Party Autonomy- An English Norm in the Indian Setting

Party autonomy is imbedded within the Indian Contract Act 1872 (hereinafter the Act) since inception.[2] The concept was never treated as alien to the Indian setting. This was in accord with the fact that the common law of England was

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[2] Atul Chandra Patra, HISTORICAL BACKGROUND OF THE INDIAN CONTRACT ACT, 1872, 4 J. INDIAN L. INST. 373 (1962).

forced upon the entire Indian subcontinent.[3] The subjugated were bereft of choice and hence had to acclimatize with the intricacies of the English law. The Act thus ended up as largely a codification of the English contract law, interspersed with alterations and additions.[4] For instance the conceptualization of offer and acceptance within the Act mirrors the position under the English law. Chitty defines offer as "willingness to contract on specified terms made with the intention that it is to become binding as soon as it is accepted by the person to whom it is addressed."[5] Section 2 (a) of the Act also evokes similar sentiments by insisting that "[w]hen one person signifies to another his willingness to do or to abstain from doing anything, with a view to obtaining the assent of that other to such act or abstinence, he is said to make a proposal."[6]

These two definitions of offer, though separated by jurisdictions, embody the idea of party autonomy. For the same is hinged on the will of the parties to determine the fate of the transactions. And this umbilical connection between the English contract law and the Act dominates the narrative. Hence both the English contract law and the Act perceives acceptance as an absolute and unqualified assent to the offer. The integration of the party autonomy norm within the Act has however surpassed its English law origins. It is celebrated and used in scenarios not envisioned by the English contract law. For instance, as per the mail box rule under the English law, contract is formed upon posting of the acceptance. The parties are thus bound in a contract, based on the presumption of a deemed consent. This was established in the case of *Adams & Others v. Lindsell & Others*,[7] in the year 1818. The rule dilutes party autonomy by imposing obligations, and is justified on the grounds of expediency. In that case the Court established that

"if the defendants were not bound by their offer when accepted by the plaintiffs till the answer was received, then the plaintiffs ought not to be bound till after

[3] M. P. JAIN, THE LAW OF CONTRACT BEFORE ITS CODIFICATION, 1972 J. INDIAN L. INST. (SPECIAL ISSUE)178

[4] R. N. Gooderson, English Contract Problems in Indian Code and Case Law, 16 CAM. L. J. 1, 67 (1958)

[5] CHITTY, ON CONTRACTS (H.G.Beale et al. eds., 2015)

[6] The Indian Contract Act, No. 9 of 1872 INDIA CODE (1872), § 2 (a).

[7] Adams & Others v. Lindsell & Others (1818) 106 Eng. Rep. 250 (KB).

they had received the notification that the defendants had received their answer and assented to it. And so it might go on ad infinitum."[8]

Accordingly, the point of contract formation was held to be the posting of the acceptance. The Act has adapted the mail box rule but with modification. Hence the contract is formed when the acceptance is posted but party autonomy is preserved.[9] As a consequence the Act permits the acceptor to change mind and revoke the acceptance later. The only caveat being that the revocation must be successfully communicated before the posted acceptance reaches the offeror.[10] The acceptor is thus conferred with a choice and has the option of either sticking with the acceptance or back out. Such a choice is not available under English law. The Act has thus clearly outshone the English law in celebrating party autonomy. Hence not only has the norm of party autonomy been adopted by the Act, it has been seamlessly adapted to the Indian setting. Another example, that establishes the importance of party autonomy within the Act, is the definition of consideration.

The Act has done away with privity of consideration, thus departing from the English contract law. As per Section 2(d) of the Act, consideration can be provided by the promisee or any other person, at the desire of the promisor.[11] The introduction of 'any other person' allows consideration to flow from strangers to the contract. Hence for the promisor it doesn't matter who is giving the consideration. On the other hand the promisee has choices in terms of complying with the desire of the promisor. For the promisee can, either on her own or through a complete stranger, satisfy the requirement of consideration. The Act though retains the essence of the English law, by insisting that a valid consideration is the one desired by the promisor.[12] Nonetheless by discarding privity of consideration, the Act prioritises party autonomy as a core principle. The Act thus ensures that the choice and will of the parties overrides the binds of the English contract law. Since, as explained in the *Dunlop* Case,[13] under

[8] *Id*.
[9] The Indian Contract Act, No. 9 of 1872 INDIA CODE (1872), § 4.
[10] *Id.*
[11] The Indian Contract Act, No. 9 of 1872 INDIA CODE (1872), § 2 (d).
[12] *Id.*
[13] Dunlop Pneumatic Tyre Company, Limited v Selfridge and Company, Limited [1915] A.C. 847 (HL) (appeal taken from Eng.).

English law both privity of consideration and privity of contract are unassailable.[14] The provisions dealing with performance of contract further re-emphasise this importance of party autonomy.

Thus whenever disputes relating to non-performance of contract arises, the innocent parties' choice matters. Accordingly, the innocent party can either rescind or keep alive a contract, upon repudiatory breach. Section 39 of the Act thus declares that upon repudiatory breach "…the promisee may put an end to the contract, unless he has signified, by words or conduct, his acquiescence in its continuance."[15] Similarly section 53 of the Act renders a contract voidable at the option of the innocent party upon repudiatory breach.[16] Section 63 is another example of the importance of party autonomy within the Act.[17] As per section 63 a party to the contract can unilaterally "dispense with" performance or "remit" the performance or "extend the time" of performance or "accept any satisfaction" in place of the original performance. And such a dispensation/ remission/ extension/ satisfaction is binding notwithstanding the lack of consideration.[18] This rule is unique to the Act for such a privilege is non-existent under English contract law.[19] The discussion above thus establishes that the Act unabashedly celebrates party autonomy.

This celebration of party autonomy culminates with section 75.[20] As per the said section, upon rescission, a party can claim both damages as well as restitution. This thus provides the innocent party with lot of options. An innocent party can limit her claim, upon proof of repudiatory breach, to restiutionary relief.[21] On the other hand the innocent party can claim only damages for such breach, as per the provisions of the Act. The innocent party thus has the autonomy to determine the remedy it wants to seek.[22] The importance of party autonomy within the Act thus seamlessly integrates an

[14] *Id.*
[15] The Indian Contract Act, No. 9 of 1872 INDIA CODE (1872), § 39.
[16] The Indian Contract Act, No. 9 of 1872 INDIA CODE (1872), § 53.
[17] The Indian Contract Act, No. 9 of 1872 INDIA CODE (1872), § 63.
[18] *Id.*
[19] Chhunna Mal Ram Nath vs Mool Chand Ram Bhagat (1928) 30 BOMLR 837.
[20] The Indian Contract Act, No. 9 of 1872 INDIA CODE (1872), § 75.
[21] Muralidhar Chatterjee vs Internatonal Film Company (1944) 46 BOMLR 178.
[22] The Indian Contract Act, No. 9 of 1872 INDIA CODE (1872), § 75.

English law concept within the Indian setting. The interplay of this concept in the context of liquidated damages needs to be now analysed. Specifically, the impact of party autonomy on section 74 needs to be understood. Importantly the said provision needs to be revisited against the backdrop of the relevant judicial decisions. Additionally, a critique of the various Supreme Court's ruling is needed to highlight the interplay of section 74 and party autonomy.

II. Section 74 and Liquidated Damages: Interpretative Ennui towards Party Autonomy

Section 74 of the Act has been rooted in the idea of party autonomy, since its inception. This is evident from the language of the first para of section 74, as it originally stood viz.

"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, the party complaining of the breach is entitled, whether or not actual damages 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."[23]

This version of section 74 was the outcome of extensive debates amongst the members of the Third Law Commission.[24] The context of the debate centered on the grant of party autonomy versus curtailment of the same. Initial proposal was for a simpler version on liquidated damages viz.[25]

"when a contract has been broken, if a sum is named in the contract itself as the amount to be paid in case of such breach, the amount so named shall be paid accordingly."[26]

This version was overbearingly in favour of preserving party autonomy and did not moot any interference from the Courts. It however got rejected and the version, as referred to above was incorporated.[27] Over the years, the courts'

[23] POLLOCK & MULLA, THE INDIAN CONTRACT AND SPECIFIC RELIEF ACTS 1275 (Nilima Bhadbhade, 14th ed. 2014).
[24] JUSTICE M. JAGANNADHA RAO, LIQUIDATED DAMAGES AND PENALTIES: EX ANTE OR EX POST METHODOLOGY, 1 SCC. J-1 (2013).
[25] *Id*.
[26] *Id*.
[27] *Id*. at J-9

interpretation of section 74, as it then was, has created a web of confused narratives. And these narratives completely missed the central idea of party autonomy. Thus in Nait Ram[28], the Allahabad High Court, declared that

"that the Court are not bound to award the entire amount of damages agreed upon by the parties in anticipation of the breach of contract…The discretion of the Court in the matter of reducing the amount of damages agreed upon is left unqualified by any specific limitation…" [29]

This interpretation given to section 74 is problematic at two levels. Firstly, it assumed as absolute, the power of the Court to interfere with the clauses on liquidated damages. And secondly it failed to notice the importance of party autonomy within the section. Such a problem with interpretation of section 74 was due to the usage of the concept of penalty. And this concept was derived from the English law. The courts did acknowledged that section 74 does away with the distinction between a penalty and liquidated damages.[30] However they ended up declaring all stipulations on damages as penalty. In H.Mackintosh v C.Crow[31], Justice Wilson declared that section 74 "does away with the distinction between a penalty and liquidated damages and this must be borne in mind in dealing with cases decided before the Contract Act…".[32] Accordingly any sum stipulated in the contract "as the amount to be paid in case of breach, it is to be treated, much as a penalty was before, as the maximum limit of damages."[33] Consequence of such an interpretation was that the enforcement of such stipulations required a party to prove its reasonability.

And such an imposition was contrary to the language of section 74, as it then was. The subsequent amendment to the section introduced in the year 1899,[34] added to the existing confusion.[35] The language of the first para of section 74

[28] Nait Ram v. Shib Dat and Ors (1883) ILR 5 All 238.
[29] *Id*.
[30] Kalachand Kyal v. Shib Chunder Roy (1892) ILR 19 Cal 392.
[31] H. Mackintosh vs C. Crow And Anr. (1883) ILR 9 Cal 689.
[32] *Id*.
[33] *Id*.
[34] *Id.*
[35] Shivprasad Swaminathan, De-inventing theWheel: Liquidated Damages, Penalties and the Indian Contract Act, 1872, 2018 CHI. J. COMP. L. 1

was amended and it is this version that is currently in force. Post amendment the first para of section 74 states that:

"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 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."[36]

The introduction of the term "penalty" in the section has further diluted the concept of party autonomy. The amendment affirms the pre-dominant view of the courts that all stipulations on damages are penalty. In *A. Muthukrishna Iyer v Sankarlingam Pillai*[37], Justice Wallis, while referring to the legislative history of section 74 observed that "even stipulations which in England would be regarded as stipulations for liquidated damages and so enforceable according to their terms might in effect be treated as penal…"[38] According to him through the amendment the "[l]egislature uses the word penal in a very wide sense and so as to include stipulations falling within the earlier part of the section for liquidated damages, which according to the English decision are not penal."[39] Evidently the interpretation of section 74 in both the pre and post amendment scenario has not promoted the concept of party autonomy. And as will be seen hereunder, the Supreme Court of India too has furthered the apathy towards party autonomy.

III. Section 74, the Supreme Court of India and A Confused Narrative: Party Autonomy Fizzles Out!

In *Fateh Chand*,[40] the Supreme Court got the chance to re-assess the interpretation of section 74. Justice Shah reiterated that the "section is clearly an attempt to eliminate the somewhat elaborate refinements made under the

[36] POLLOCK & MULLA, THE INDIAN CONTRACT AND SPECIFIC RELIEF ACTS 1275 (Nilima Bhadbhade, 14th ed. 2014)
[37] A. Muthukrishna Iyer v. Sankarlingam Pillai ILR (1913) 36 Mad 229 (India).
[38] *Id.*
[39] *Id.* 249
[40] Fateh Chand v. Balkishan Das 1964 SCR (1) 515(India).

English common law in distinguishing between stipulations providing for payment of liquidated damages and stipulations in the nature of penalty."[41] He then declares that while enforcing the stipulations on damages the courts are duty bound to award reasonable compensation. And in the process the courts cannot "award of compensation when in consequence of the breach no legal injury at all has resulted…".[42] As per Justice Shah legal injury has to be established by assessing the "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."[43] Thus as per Justice Shah the stipulation on damages are presumed to be penalty and unreasonable unless proved to the contrary. Such an approach clearly rejects the sanctity of party autonomy.

Post Fateh Chand[44] however the Supreme Court's narrative on the issue has generated more confusion than clarity. In Maula Bux v. Union of India,[45] explaining the scope of section 74, the Supreme Court held that "It is true that in every case of breach of contract the person aggrieved by the breach is not required to prove actual loss or damage suffered by him before he can claim a decree…"[46] It goes on to lay down that "Where the Court is unable to assess the compensation, the sum named by the parties if it be regarded as a genuine preestimate may be taken into consideration as the measure of reasonable compensation... Where loss in terms of money can be determined, the party claiming compensation must prove the loss..."[47] One cannot get a more confused narrative than this. At one end the court is proclaiming that stipulations on damages are not dependent on proof of actual loss. Hence such stipulations are genuine, valid and enforceable. On the other hand it insists on proof of actual loss in situations where such loss is determinable. In the process the court fails to lay down a framework to be used for identifying such varied situations.

[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] Fateh Chand v. Balkishan Das 1964 SCR (1) 515(India).
[45] Maula Bux v. Union Of India 1970 SCR (1) 928(India).
[46] *Id.*
[47] *Id.*

The next significant decision on section 74 is ONGC Ltd v. Saw Pipes. Ltd.[48] A reading of this judgment will firmly establish the apathy of the Supreme Court towards party autonomy. Further the decision fails to provide any clarity on the scope of section 74. For section 74 is described by the court as one dealing with "penalty stipulated in the contract".[49] The use of the term penalty disregards the nuances of the language of section 74. Consequently, the court fails to reflect on the extent to which the concept of party autonomy is embedded within section74. As one reads through this judgment the lack of clarity becomes more pronounced. For the court declares that "[i]n some contracts, it would be impossible for the court to assess the compensation arising from breach and if the compensation contemplated is not by way of penalty or unreasonable, the court can award the same if it is genuine pre-estimate by the parties…".[50] Evidently the confusion created in Maula Bux[51] is carried forward in the ONGC case.[52]

For if section 74 deals with penalty, it obviously cannot at the same time deal with genuine pre-estimate of loss. Since the latter means that the courts ought to in every case regard the stipulation on damages as valid. On the other hand if such stipulations are by default penalty, then the courts are to award only reasonable compensation subject to proof of actual loss. However in this judgment the court holds that "in every case of breach of contract, the person aggrieved by the breach is not required to prove actual loss or damage suffered by him before he can claim a decree."[53] This is reiteration of the Maula Bux[54] ratio. The other problem with the judgment in the ONGC[55] case is that it has drastically reduced the importance of section 74. One can go to the extent of arguing that section 74 has now to be read as an appendage to section 73.

[48] Oil & Natural Gas Corporation Ltd v. Saw Pipes Ltd (2003) 5 SCC 705 (India).
[49] *Id.*
[50] *Id.*
[51] Maula Bux v. Union Of India 1970 SCR (1) 928 (India).
[52] Oil & Natural Gas Corporation Ltd v. Saw Pipes Ltd (2003) 5 SCC 705 (India).
[53] *Id.*
[54] Maula Bux v. Union of India 1970 SCR (1) 928 (India).
[55] Oil & Natural Gas Corporation Ltd v. Saw Pipes Ltd (2003) 5 SCC 705 (India).

In explaining the scope of section 74 the court declares that "[s]ection 74 is to be read along with Section 73"[56] and the "[i]f the terms are clear and unambiguous stipulating the liquidated damages in case of the breach of the contract…party who has committed the breach is required to pay such compensation and that is what is provided in section 73 of the Contract Act.".[57] Section 73 of the Indian Contract Act deals with situations where there are no stipulation on damages within the contract. In other words the damages are to be ascertained after the breach. They have not been pre-determined or ascertained at the time of formation of contract. Evidently therefor section 73 and section 74 deals with two completely different scenario. Accordingly, they cannot be read together for they are meant to serve two different purposes. Section 73 codifies the English law on damages and requires the parties to establish proof of actual loss. The same is to be done subject to the rules specified therein.

Thus the parties have to either establish that the loss arose naturally from the breach or the parties knew at the time of formation, as likely to result from the breach. Clearly then in the absence of such proof the court cannot award any damages except a nominal one. In contrast section 74 permits and facilitates the parties to pre-estimate the loss at the time of formation of contract. Such pre-estimation are meant to provide them with the damages in the event of a breach. Hence there is no scope of any further proof to be furnished by the parties to the contract except the proof of breach. Supreme Court has itself recognised this distinction in the case of Chunilal V. Mehta v. The Century Spinning.[58] Justice Mudholkar, delivering the judgment for the five judge bench, declared that "when parties name a sum of money to be paid as liquidated damages they must be deemed to exclude the right to claim an unascertained sum of money as damages."[59] This is a clear and definite statement highlighting the distinction between ascertained and unascertained damages. Continuing with this line of reasoning Justice Mudholkar holds that the "right to claim liquidated damages is enforceable under section 74… and [w]here the parties have… specified the

[56] *Id.*
[57] *Id.*
[58] Sir Chunilal V. Mehta and Sons, Ltd vs The Century Spinning and Manufacturing CO. 1962 SCR Supl. (3) 549 (India).
[59] *Id.*

amount of liquidated damages there can be no presumption that they… intended to… claim instead a sum of' money which was not ascertained or ascertainable at the date of the breach."[60] The Supreme Court ignored its own dictum in ONGC[61] by insisting that section 74 has to be read with section 73. In the process it blurred the distinction between pre-estimated damages or liquidated damages and unliquidated or unascertained damages.

The contradictions and confusion created through the ONGC decision is starkly clear from a reading of the Supreme Court's judgment in Steel Authority Of India Ltd.[62] The Supreme Court, after analyzing the specific facts therein, held that "It is true that Section 74 declares the law as to liability upon breach of contract where compensation is by agreement of the parties pre-determined. However in the absence of any agreement specifying damages for the breaches alleged by the respondent, Section 74…is not at all attracted".[63] Sadly the ratio of *ONGC*[64] is now firmly entrenched within the Indian jurisprudence. The same is evident from the Supreme Court's judgment in *M/S. Kailash Nath Associates*.[65] In explaining the scope of section 74, the court held that the determination of reasonable compensation under section 74 has to be in accord with the "well known principles that are applicable to the law of contract, which are to be found inter alia in Section 73 of the Contract Act."[66] Further "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."[67] This sums up the current chaos that the Supreme Court has introduced in the narrative on section 74. That has also ensured that the concept of party autonomy has fizzled out from the interpretative framework of section74.

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[60] *Id*
[61] Oil & Natural Gas Corporation Ltd vs Saw Pipes Ltd (2003) 5 SCC 705 (India).
[62] Steel Authority of India Ltd vs Gupta Brother Steel Tubes Ltd (2009) 10 SCC 63 (India).
[63] *Id.*
[64] Oil & Natural Gas Corporation Ltd vs Saw Pipes Ltd (2003) 5 SCC 705 (India).
[65] Kailash Nath Associates v Delhi Development Authority and Another (2015) 4 SCC 136 (India).
[66] *Id.*
[67] *Id.*

IV. Resurrecting Party Autonomy and Section 74: Time to Adapt the Legitimate Interest Test?

It's time that the chaos existing within the interpretative framework of section74 is resolved. The same needs to be done to resurrect the concept of party autonomy. Further the uncertainty introduced in the discourse on section 74 needs to be sorted out to secure contractual transactions. The essential idea behind facilitating usage of stipulation on damages is allocation of risk arising from the breach. Through such stipulations the parties pre-determine the amount of risk at the time of formation of contract. Hence uncertainty surrounding the validity of such stipulations undermine the process of formation of contract. For the formation of a valid contract is premised on consensus-ad-idem. There are well defined grounds on which the validity of a contract is challenged. The parties thus have a ready to refer checklist that helps them form valid contracts. This settled process of contract formation is disrupted the moment the grounds determining contractual validity becomes uncertain. Considering that contracts are needed for transaction ranging from consumer to commercial, certainty is absolutely essential.

The certainty, referred to hereinabove, refers to the enforceability of the clauses and the contract. As explained above, the various decision on the scope of section 74 has disrupted this certainty. There are no guidelines to judge whether a stipulation is genuine or a penalty. The only refrain given is that "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."[68] And this indicates nothing and clarifies nothing for the contracting parties. The process of clearing the confusion on the issue thus needs to begin by re-reading section 74. The first para of section 74 is the relevant part, which states that

"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

[68] Kailash Nath Associates v Delhi Development Authority and Another (2015) 4 SCC 136, 163 (India).

not exceeding the amount so named or, as the case may be, the penalty stipulated for."[69]

This is the para that has been interpreted in the manner discussed hereinabove. The current interpretative structure of section 74 over-emphasises on the word 'penalty', as used therein. Penalty is a term having origins in English law. In English law this term was developed in to an equitable doctrine and applied to assess the validity of defeasible bonds. Over a period of time the common law too started using the doctrine of penalty. Eventually the doctrine came to be used by the common law courts to assess the enforceability of stipulation on damages. Accordingly they distinguished between "a provision for the payment of a sum representing a genuine pre-estimate of damages and a penalty clause in which the sum was out of all proportion to any damages liable to be suffered."[70] This approach of the common law courts thus curtailed all possibilities of preserving party autonomy. The outcome was that all stipulations on damages were to be tested under the penalty rule. Common law courts enforced what they termed as liquidated damages and rendered void stipulations found to be penal. This distinction between liquidated damages and penalty "has remained fundamental to the modern law, as it is currently understood" in English contract law.[71]

Section 74 was drafted and incorporated in the Act, to override this complex history of the penalty rule. As has been mentioned hereinabove, the original version of this section, as proposed by the Third Law Commission stated that

"When a contract has been broken, if a sum is named in the contract itself as the amount to be paid in case of such breach, the amount so named shall be paid accordingly."[72]

In proposing this version the Third Law Commission justified the same on the ground that it obliterates the complexity under English law. Accordingly, the payment of stipulated sum was to be the only requirement. The Indian law was

[69] The Indian Contract Act, No. 9 of 1872 INDIA CODE (1872).
[70] Cavendish Square Holding BV v Talal El Makdessi and Another [2015] UKSC 67. (UK).
[71] *Id.*
[72] Justice M. Jagannadha Rao, LIQUIDATED DAMAGES AND PENALTIES: EX ANTE OR EX POST METHODOLOGY, 1 SCC. J-1 (2013).

to have no regard for the distinction between liquidated damages and penalty.[73] This proposal was objected to and the Select Committee ended up drafting and incorporating a completely different version which got codified as section 74.[74] As mentioned hereinabove, section 74, as it originally stood, permitted awarding reasonable compensation. It thus appears that the Select committee favoured "turning all the liquidated damages into penalty".[75] The 1899 amendment to section 74 has not changed this requirement. Hence what we get from a plain reading of section 74 is that irrespective of the quantum stipulated, only reasonable compensation is to be given. The stipulation is to act only as the upper ceiling and the reasonable compensation cannot exceed the ceiling.

The courts, as seen hereinabove, has read the section in keeping with the view point of the Select Committee. Unfortunately, they have till date, not determined the objective parameters to asses reasonable compensation under this section. It is submitted that one can find the clue to assess reasonable compensation within the section itself. And accordingly there is neither a need nor a necessity to refer to section 73 and its jurisprudence. The courts by doing so are missing the point completely. Even if one accepts that the Select Committee did intend to treat all stipulations as penalty, it still does not justify such reference. For the first paragraph of section 74, read holistically can lend itself to mean that the proof of actual loss is not needed. The only thing the courts need to assess is reasonability of the stipulation. And in doing so the burden ought to be placed on the party challenging the validity of such stipulations. If the party so challenging, is not able to discharge the burden of such a challenge, the stipulation ought to be enforced.

As to the assessment criteria to judge the validity of such stipulations, one has to revert to the theory of consensus-ad-idem. Since the stipulations on damages are incorporated at the time of formation of contract, its validity ought to be judged like in case of other clauses. Hence if it's established that the parties have freely consented to such stipulations, the same ought to be held valid. Apart from proof based on the lack of consent or quality of consent, no other proof ought to be entertained. There might however be an argument for

[73] *Id.*

[74] *Id.*

[75] ATUL CHANDRA PATRA, HISTORICAL BACKGROUND OF THE INDIAN CONTRACT ACT, 1872, 4 J. INDIAN L. INST. 373 (1962).

applying equitable considerations like the doctrine of unconscionable bargains. However the same should be applied subject to the limits, as explained by the Supreme Court in the Central Inland Water Transport case.[76] As per Justice Madon

"the courts will not enforce… an unfair and unreasonable contract, or an unfair and unreasonable clause in a contract, entered into between parties who are not equal in bargaining power….". Accordingly he declared that this doctrine will apply "where a man has no choice… but… to accept a set of rules as part of the contract, however unfair, unreasonable and unconscionable a clause in that contract…"[77]

He then goes on to set the qualification upon the application of this doctrine by stating that "[t]his principle, however, will not apply where the bargaining power of the contracting parties is equal or almost equal. This principle may not apply where both parties are businessmen and the contract is a commercial transaction."[78] This is an important guideline while considering the validity stipulation on damages. Thus barring contracts involving persons who are economically weak and vulnerable, stipulations on damages in all other contracts are to be enforced. And equitable consideration should have no role to play, except in the situation enumerated above. The point that one is trying to put forth is that the section 74 needs to be given its due without being subservient to the requirements of section 73. The author accepts that the legislative intent was to treat all stipulations referred to under section 74 as penalty. At the same time the rationale behind this intent cannot be ignored. And that was to completely deviate from the English law on the issue. As has been explained in the Cavendish Square Holdings case,[79] the penalty rule has led to lot of problems within the English law.

As per Lord Neuberger and Lord Sumption the penalty rule in England "is an ancient, haphazardly constructed edifice which… should simply be demolished, and in the opinion of others should be reconstructed and extended. For many

[76] Central Inland Water Transport Corporation Limited and Another v Brojo Nath Ganguly and Another (1986) 3 SCC 156.
[77] *Id.*
[78] *Id.*
[79] Cavendish Square Holding BV v Talal El Makdessi and Another [2015] UKSC 67.

years, the courts have struggled to apply standard tests formulated more than a century ago for relatively simple transactions to altogether more complex situations."[80] It is this view point that has led the UKSC to revisit and reformulate the approach towards liquidated damages. Accordingly Lord Neuberger and Lord Sumption formulate that the "real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss… A damages clause may be neither or both. The fact that the clause is not a pre-estimate of loss does not… mean that it is penal." [81]Accordingly they hold that the question to be asked while assessing the validity of a stipulation on damages is "whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation."[82]

They further declare that "[i]n a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach."[83] Lord Mance declared that "…that the agreed sum [stipulation on damages] must not have been extravagant, unconscionable or incommensurate with any possible interest in the maintenance of the system, this being for the party in breach to show."[84] Accordingly he was of the firm view that "[w]hat is necessary in each case is to consider… whether any (and if so what) legitimate business interest is served and protected by the clause…".[85] Lord Hodge too agreed with the legitimate interest test, developed by the other Law Lords, as referred to hereinabove. He accordingly held that "the correct test for a penalty is whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract."[86] Lord Toulson too adopted this line of reasoning as the correct measure to determine the validity of a stipulation on damages. In

[80] *Id.*
[81] *Id.*
[82] *Id.*
[83] *Id.*
[84] *Id.*
[85] *Id.*
[86] *Id.*

short all the Law Lords of the UKSC agreed that the only assessment to be made to judge the validity of a stipulation on damages is the legitimate interest of the parties.[87] In the process they ended up re-visiting and reformulating the tests developed by Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd*.[88] As per the tests developed by Lord Dunedin ""(a)…the provision would be penal 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".[89] Further a stipulation on damages will be penal if "(b)… the breach consisted only in the non-payment of money and it provided for the payment of a larger sum".[90] A stipulation on damages will also be penal if "(c)… if it was payable in a number of events of varying gravity."[91] The final test was that "(d)… it would not be treated as penal by reason only of the impossibility of precisely pre-estimating the true loss.".[92]

The author herein would submit that the Supreme Court of India could have re-formulated its approach decades ago. This is so because of the comparative advantageous position the Supreme Court is in due to the provisions of the Act. Further, as argued above, the legislative intent too was to completely discard the complexities of the penalty rule under English law. Hence the task was clearly cut out for the Supreme Court of India to develop an Indian position on liquidated damages stipulations. Given that there is a well-defined chapter on formation of contract within the Act, section 74 could have been read in light of the same. Further in cases of all disputes relating to formation and performances, the courts do refer to the terms of contract. And such reference is used to deduce the intention of the parties. In determining the validity of stipulation on damages, the approach should not have been any different. The biggest mistake of the Supreme Court of India has been to treat stipulation of damages as akin to un-ascertainable damages. This has resulted into the ensuing confusion. Hence we find that at one hand they are stating that actual loss need not be proven and the stipulation will be enforced. At the other end they are

[87] *Id.*
[88] Dunlop Pneumatic Tyre Company, Limited v New Garage And Motor Company, Limited [1914] UKHL 1.
[89] *Id.*
[90] *Id.*
[91] *Id.*
[92] *Id.*

insisting on proof of actual loss as per the norms laid down in section 73. This is fundamentally wrong because the considerations for assessing un-ascertainable damages are played out with reference to the date of breach. Hence the party has to establish the net loss based on the evidence on the date of the breach. This is justified by the rationale that in contract damages are awarded to take the parties to the position in which they would have been had the contract been performed. On the other hand a stipulation on damages is the result of a bargain and is settled in on at the date of formation of contract. Hence the only thing that matters is interpretation of the contract with reference to the intention of the parties. That automatically leads to the ascertainment of the legitimate interest of the parties. Such consideration are taken into account for example to assess whether time is the essence of the contract. Similarly intent and interest of the parties at the time of formation of contract is taken into account to assess the status of a term as a condition or a warranty.

A stipulation on damages should be no different and has to be treated like any other contractual clause. For a stipulation on damages is fundamentally different from the concept of unascertainable/unliquidated damages. The fact that section 74 is clubbed with the other sections on damages in Chapter VI of the Act, it cannot be interpreted in the same manner. Alternatively even if we are to argue that section 74 needs to be read in the same way as section 73, the current interpretative approach of the courts are not justifiable. Section 73 allows an innocent party to claim damages based on two principles. First, a party can claim damages that are natural outcome of the breach and are obvious or foreseeable at the time of the formation of contract. The other is that if the parties are informed and have knowledge about some special circumstances then the innocent party can claim damages for that loss as well. Application of these principles to the interpretational framework of section 74, should lead to a simple conclusion that it satisfies the second principle. For the stipulation on damages automatically establishes knowledge on the part of the parties to the contract. Hence from that perspective also its validity can only be challenged on the usual grounds applied for testing the validity of contractual clauses. The proof of actual loss, as mandated by the Supreme Court in the cases discussed hereinabove is thus patently wrong.

Finally, section 74 cannot be devoid from the considerations applied to the statutory interpretations. Even if one argues that the legislative intent required

all stipulation on damages to be treated as penalty, this cannot be treated as an unwavering rule. The section needs to be read dynamically to cater to the ongoing developments in the field of contractual transactions.[93] The Select Committee's reasons for treating all stipulations as penalty were different and are no longer valid in today's world. Considering the complexities of modern contractual transactions, it is neither advisable nor justifiable to apply an arcane approach to section 74. The need of the hour is to suit the legislation to the demands of the modern times.[94] As has been explained above one has to change the perspective. The law need not be amended for it contains within itself the tools to interpret it dynamically. Considering the Act has witnessed very few amendments in the centuries that it has survived, is evidence of its inherent dynamism. Further over the years Supreme Court too has expanded the ambit of the various provisions of the Act through dynamic interpretations.[95] In doing so court has taken inspiration from the English law. It may sound ironical but English law has given us important insights whenever we are in the danger of rendering the Act otiose. Hence in the light of UKSC's formulation of the legitimate interest test, Supreme Court of India too can adapt the same while interpreting section 74. And that will resurrect the concept of party autonomy and secure its rightful place within section 74.

V. Conclusion

The party autonomy concept has been one of the greatest import from English contract law within the Act. And it is time that the courts in India give full flow to the concept to clear the confusion on liquidated damages. The language of section 74 is dynamic enough to accommodate the concept of party autonomy. A careful reading of the said section establishes that the concept of party autonomy is embedded with the section. The courts need to only change their perspective to resurrect the concept. Towards this end the legitimate interest test is a useful tool and can help the courts in preserving party autonomy as well as enforcing the stipulation on damages. The UKSC's formulation of the

[93] JUSTICE G.P. SINGH, PRINCIPLES OF STATURY INTERPRETATION (Justice AK Patnaik 14th ed. 2016).

[94] WILLIAM N. ESKRIDGE, JR, DYNAMIC STATUTORY INTERPRETATION, 135 U. PA. L. REV. 1479 (1987).

[95] Bhagwandas Goverdhandas Kedia v M/s. Girdharlal Parshottamdas and Co. 1966 AIR 543.

legitimate interest test is a useful reference for the courts to cut through the current chaos. Application of the legitimate interest test will enable the courts to treat the stipulation on damages as akin to any other contractual clause. Hence the validity of such stipulations will be judged based on the principles of consensus ad-idem and valid consent. The current practice to test the validity of such stipulations based on the proof of actual loss needs to be discarded. For though the stipulation is on liquidated damages, nonetheless it is the outcome of a bargain. Being incorporated at the stage of formation of contract it is different from un-ascertainable damages. Thus the courts need not treat stipulation on liquidated damages at par with unliquidated damages. Such an approach allows the courts to use legitimate interest test to uphold party autonomy and correct the discourse on liquidated damages.