

Liquidated Damages Clause in Commercial Contracts: A Pakistan's Perspective

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Economists believe that if the legal remedy for breach is expectation damages, the idea of efficient breach allows us to forecast when parties will choose to breach a contract. On the other hand, the economic premise of rational wealth-maximizing actors fails to reflect significant nonmonetary values and incentives that impact behavior in predictable ways. People act following shared community norms, such as the moral norm of honoring pledges, when interpersonal duties are informal or underspecified. However, when the parties specify or otherwise formalize punishments for uncooperative behavior, it becomes more strategic and self-interested. The remedy for breach is made apparent with a liquidated-damages

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clause. This article will highlight the issues about the cure for breach in cases where liquidate damages clause is exploited, focusing on the Common law and precedents by eminent judges, including Pakistan's legislation.

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1. Introduction

The need for certainty and intricacies to be dispensed with in a high-value commercial contract has rendered the clause of liquidated damages an integral part of the commercial contracts. Liquidated damages are the pre-estimated damages or amount of compensation that the parties mutually agree on at the time of contract execution and that is to be paid on a daily, weekly, or monthly basis until the job is completed in the event of an agreed breach of contract.¹ Lord Dunedin described liquidated losses in 1913 as “a real covenanted pre-estimate of damages.”² One of the benefits of liquidated damages is that the claimant does not have to prove the amount of loss s/he suffered as a result of the contract's breach or late performance; instead, the defaulter should compensate the claimant according to the pre-estimate amount agreed upon by the parties. If the contract forbids the client from pursuing liquidated damages, or if actual losses differ dramatically from those projected when the contract was signed, the customer may seek un-liquidated or actual damages from the court.

Liquidated damages clauses provide the contracting parties with more control and can protect them from the cost of an infringement. The capacity to compare the price of performance with the cost of breach would benefit both parties.³ Un-liquidated damages are usually determined through the intervention of the court based on the actual harm done to the innocent party.⁴ Although the courts are hesitant to intervene in the matter of liquidated damages, if the sum is either legitimate or excessive, the courts may deem it a penalty, rendering it unenforceable.⁵ A liquidated damages clause is standard in construction, IT, outsourcing, and employment contracts.

A liquidated damages clause is appealing for several reasons. Firstly, such a provision informs the parties of the scope of their potential obligation at the time of contract creation. Second, if there is one breach, the condition saves the applicant

of the expenditure and uncertainty associated with demonstrating loss. Third, it guarantees that commitments are honoured by serving as a motivator to perform. Finally, it enables the party to agree to “non-punitive” protection beyond the technological boundaries of common law damages.⁶

The primary purpose of this research is to analyze whether the liquidated damages clause in the contract can benefit the contracting parties pertaining to breach and how the law strengthens this concept. This article is divided into six parts including Introduction and Conclusion. Part two will present whether liquidated damages ended upon the termination of the contract. Part three will demonstrate when liquidated damages become a penalty. Part four will deal with the concept of liquidated damages in Pakistan. Part five will explain the role of the cap in liquidated damages.

2. Whether Liquidated Damages Ended upon the Termination of the Contract?

Goetz and Scott stated that economists believe that if the legal remedy for breach is expectation damages, the idea of efficient breach allows us to forecast when parties will choose to breach a contract.⁷ On the other hand, the economic premise of rational wealth-maximizing actors fails to reflect significant nonmonetary values and incentives that impact behavior in predictable ways. People act under shared community norms, such as the moral norm of honoring pledges, when interpersonal duties are informal or underspecified. However, when the parties specify or otherwise formalize punishments for uncooperative behavior, it becomes more strategic and self-interested. The remedy for breach is made apparent with a liquidated-damages clause. Additionally, liquidated damages should be paid in case of a specific agreement violation, such as late performance. When a breach occurs, the claiming party should notify the other party of its intent to levy liquidated damages and then follow the contract's procedure.⁸

The questions may arise here: What happens if either party terminates an agreement? Would they still claim liquidated damages? Different case laws from time to time change the view on when liquidated damages could claim or when not. In “*British Glanzstoff v. General Accident*,” the House of Lords was debating whether the appellant may recover liquidated damages from the insurance as a consequence of the hindrance in completion due to the contractor's suspension and

demobilization.⁹ The House of Lords ruled that they could not recover it, arguing that the liquidated damages rules applied only when the contractors had fulfilled the contract and “did not apply where control of the agreement had transferred out of their hands.”¹⁰

In *Shaw* case,¹¹ the England and Wales High court held that, in terms of liquidated damages, the employer is entitled to liquidated damages at the stipulated level for any time of inexcusable delaying up to and including the day the contract is discontinued. However, following the termination date, the parties are no more compelled to execute their essential contractual responsibilities; therefore, the contractor’s responsibility to finish by the execution date no more exists, and the Clause for liquidated damages thus becomes immaterial.¹² Clause 8.7 of the FIDIC (1999 Red Book) contract conditions provides for the payment of liquidated damages for project delays and adds that these delay charges are the only damages payable from the contractor for such failure unless the Works are terminated according to Sub-Clause 15.2 before completion.¹³ This is problematic because it acknowledges the possibility of unliquidated damages after termination without clearly prohibiting liquidated damages from continuing. The Judges in the *Shaw and Glanzstoff* cases had the same philosophy.¹⁴ In *Hall and Crestream* case, the judges set a different and unique principle, although not admirable in practice, that the clause of liquidated damages remains in field until the second contractor achieves completion.¹⁵ This principle was only adopted in a few cases as it is not logical for someone to pay for the cracks of other contractors after the termination of the contract. Furthermore, this logic is more suitable for general damages than liquidated damages.

Finally, in the *Triple Point Technology* case, the UK Supreme Court clarified the essential moot point of whether a contract terminated before completion of the project nullifies the right to claim liquidated damages.¹⁶ The UK Supreme Court confirms that if the contract is terminated before the project is finished, the right to receive liquidated damages is still valid. Party can claim liquidated damages that accrued before contract termination or completion of the project, and loss accrued post-termination can be recovered only in the form of general damages.¹⁷ The abovementioned UK Supreme Court judgment is beneficial for the employers who, in the past, could not get liquidated damages due to termination of contract or completion of the project and may have faced difficulties in proving the general damages in courts.

3. When Liquidated Damages Become Penalty?

As discussed above, liquidated damages are pre-estimated damages that the parties mutually agreed upon at the time of the contract. Still, suppose the amount of the liquidated damages seems excessive to the actual harm suffered or deters another party from completing the work. In that case, courts usually consider it a penalty and punishment and will not implement the clause. Therefore, this prevents the innocent party from paying unreasonable compensation. In *Law v. Local Board of Redditch*, Justice Lopes of House of Lords UK held that the difference between liquidated damages and penalties would be based on the parties' aim to obtain information from the entire contract.¹⁸ The sum mentioned is a penalty if the purpose is to enforce contract performance by demanding a fine or penalty. Still, it is liquidated damages if the intention is to assess damages for contract violation. Liquidated damages claims are based on (1) the complexity of calculating actual damages and (2) the claim's reasonableness.¹⁹ "Damages for either party's violation may be liquidated in the agreement," the Restatement says, but only to an amount that is fair in light of the anticipated or actual damage caused by the breach and the difficulty of showing a loss.²⁰ When liquidated damages seem reasonable, it is binding upon the parties. However, it is not binding upon the party when it appears to be a penalty. The claimant only claims general damages in that scenario. Furthermore, the party advocating for the damages clause's illegality bears the burden of the weight for proving that it constitutes a punishment.²¹ However, few states place the burden of the weight on the side seeking liquidated damages to indicate that the liquidated damages are genuine²² and the court is not bound by the name given by parties to an agreement to the sum payable on default.²³ Hence, a penalty is cruel and unenforceable under any name.

Lord Dunedin gave the formative analysis of penalty doctrine in the *Dunlop* case:²⁴

1. While contracting parties' use of terms like 'penalty' or "liquidated damages" may indicate what they mean on the surface, the terminology is not conclusive. The court must determine whether the amount in question is a penalty or liquidated damage.
2. A penalty is a monetary payment made in the terrorem of the offending party; liquidated damages are a genuine covenanted pre-estimate of damage.
3. Whether a number mentioned is a 'penalty' or "liquidated damages" must be

determined based on the terms and underlying conditions of each contract at the time of contract origination rather than at the time of the violation.

Furthermore, Goetz and Scott maintained:

- A penalty is any quantity plainly ‘extravagant’ and ‘unconscionable’ in proportion to the maximum potential damage that could come from the breach, according to Lord Dunedin.
- A penalty is imposed when a breach is caused by an incapacity to pay a sum of money that is less than the prescribed liquidated damages total.
- An amount will not always be interpreted as a penalty since a real pre-estimate is impossible. Likewise, adopting a liquidated damages term in this situation may imply that the sum was part of the parties' business arrangement.
- The use of similar liquidated damages amounts for several possible violations that may have significant but modest financial consequences creates a clear and convincing inference that the value is a punishment.²⁵

When identifying the difference between a “penalty clause” and a “liquidated damages provision,” the judges followed the precedent set by the *Dunlop* case.²⁶ The standard in the *Dunlop* case, on the other hand, is stringent and rigid, putting a stumbling block in the way of the parties’ contractual freedom.²⁷ “The court should be careful not to establish an overly high bar and remember what the parties have agreed should ordinarily be upheld,” Lord Woolf, speaking for the Privy Council, said, not least because “any other approach will lead to undesired uncertainty, especially in commercial transactions.”²⁸ According to the Court of Appeal, the underlying question in the *Murray* case is whether the honest party’s principal goal was to add a payment clause with a high enough sum to prevent the other party from breaking, rather than compensating the other party.²⁹ According to the Court, “there is no presumption that a non-compensatory component renders the clause’s intent “deterrent” and hence unconstitutional. Otherwise, the method would become very rigid and dogmatic.”³⁰ Maryland courts in *Barrie School case* held that if a [liquidated-damages] provision meets two fundamental conditions, it would be upheld as lawful and not a punishment. First, the provision must include a reasonable assessment of probable damages when the contract was executed. Second, the injuries must have been impossible or extremely difficult to estimate at the time of contracting.³¹

In the case of “*Cavendish Square Holding BV*,”³² however, due to the rigidity of the Dunlop rule, the UK Supreme Court reviewed the precedent set in the Dunlop case underpinning contractual penalty provisions and held a new test to evaluate the penalty clause. Lord Hodge stated: “The correct criteria for a penalty are whether the money or remedy prescribed due to a breach of contract is excessive or unconscionable, taking into account the innocent party’s interest in the contract’s fulfillment.”³³ An extreme gap between the specified sum and the maximum degree of damages that may conceivably occur from the violation would amount to punishment and be invalid when applied to a clause describing the number of injuries to be paid in the case of a breach. The Cavendish decision safeguarded the party’s legitimate interest, which did not have to be an actual predetermine loss; if the claimant can show that the penalty clause protects the claiming party’s interest/right and is not “exorbitant or unconscionable,” they are not required to pay a loss.³⁴

4. The Concept of Liquidated Damages in Pakistan.

In Pakistan, there is no specific statute addressing liquidated damages. The Contract Act of 1872 covers the cases of breach in which no amount of compensation is specified in the agreement. The compensation should be determined strictly based on the loss accrued to either contracting parties in the ordinary course of things due to the breach or the parties knew would be the likely result of the breach when they made the contract.³⁵

Section 74 of the Contract Act of 1872 states that where a sum is named in the contract itself as the amount to be paid in the event of a breach, or if the agreement contains any other penalty stipulation, the party complaining of the breach is entitled to receive reasonable compensation from the party who has broken the contract, not exceeding the amount so named, or the penalty so stipulated, regardless of the proof of any actual damage or loss. Section 74 is often misinterpreted to cover liquidated damages in the same way common law liquidated damages do.³⁶ A bare reading of the above section envisaged that Section 74 only hints at liquidated damages and is more focused on the concept of reasonable penalty in terrorem. Furthermore, it does not aid the awarding of pre-estimated damages without proof, but threatens the promisor to comply with the contract or pay a reasonable remuneration from the pre-determined amount or penalty.³⁷

In the case of *Province of West Pakistan v Messers Mistri Patel & Co*, a six-member bench of Pakistan's Supreme Court interpreted Section 74 for the first time.³⁸ Messers Mistri Patel & Co offered the Sindh government a PKR 33-4 per bag of two and a half maunds for four thousand tons of broken rice. The Sindh government accepted the offer under the condition that the company submit cash or bank guarantee for 5% of the total value of the products and the commodities be lifted within three months of approval. The guarantee will be encashed if the things are not raised and the remaining articles will be discarded.³⁹ Due to business considerations, the corporation failed to remove the products before the deadline, which finally brought the Sindh government to sell the remaining commodities for a profit. The Sindh government has thus launched a lawsuit seeking damages equal to 5% of the total value of the products. The case was dismissed by both the High Court and the Supreme Court of Pakistan. The Pakistan's Supreme Court held: "The distinction between "liquidated damages" and 'penalty' that exists in English law is not recognized by Section 74 of the Contract Act" for the following reasons⁴⁰:

- Under Common Law, a realistic pre-estimate of losses agreed upon by the parties is deemed liquidated damages. A contract clause in terrorem, on the other hand, is a punishment. In the case of liquidated damages, the parties are bound by the contract. On the other hand, the court declines to enforce punishment and provides suitable compensation to the injured party;
- The court's decision to award compensation under Section 74 of the Contract Act will be based on the court's assessment of adequate compensation in light of the facts and circumstances of the case, up to the contract's maximum value; and
- Whether or not actual harm or loss was incurred due to the breach, an injured party has the right to seek reimbursement from the party who violated the contract.

The Pakistan's Supreme Court refused to grant suitable compensation because the government gained from selling the remaining products. It would be unreasonable for the government to forego the contract's stipulated penalty. As a result, a claimant is only eligible for remuneration in the amount specified in the agreement or liability under Section 74 if the claimant can show that the contract was breached.

In the case of *Messrs Khanzada Muhammad Abdul Haq Khan Khattak & Co. vs Wapda*, the Pakistan's Supreme Court somehow adopted a theory of liquidated damages of common law and awarded damages that was settled by the parties in

the contract, holding that the contractual parties had calculated a pre-estimate of the anticipated loss.⁴¹ The appellant was obligated to pay the respondents under the contract's terms since he failed to fulfil half of the agreement. The Supreme Court also held that liquidated damages [are] not punitive and the parties [can] agree on a specific amount as liquidated damages to avoid the difficulty of determining the actual damages that may accrue against the defaulting party due to the contract's breach ostensibly to prevent future estimates and conflicts.⁴²

In the latest judgment of *Orient Power Company (Private) Limited vs Sui Northern Gas Pipelines Limited* case, the Pakistan's Supreme Court also adopted the same analogy and refused to grant reasonable compensation as the appellant failed to prove breach of contract.⁴³ The Supreme Court held that the parties [are] allowed to compensate actual damages up to the amount stipulated in the contract where an amount [is] referenced in the contract as a penalty payable on breach of contract. In the case of liquidated damages, however, a claimant [is] allowed to recover the same from the opposite party in the event of contract breach.⁴⁴ Suppose the court deems the amount stipulated in the contract as liquidated damages are too severe or unreasonable. In that case, the Court is authorized to decline to award that amount and instead determine an appropriate amount given the circumstances.

A perusal of the abovementioned judgments reflects that Pakistani Court did not recognize the concept of liquidated damages like the UK Courts. Penalty clauses are recognized by English law, although they are reluctant to be enforced by awarding punitive sums in whole and without proof. But Pakistani law allows the contracting parties to agree on a penalty clause. The phrase "penalty specified for," as used in Section 74 of the Contract Act of 1872, justifies its use in a contract governed by Pakistani law. Pakistani Courts do not distinguish between a penalty and a liquidated damages provision, either. Pakistani Courts are reluctant to award damages that represent a genuine pre-determine of the losses agreed between the contract parties without establishing a contract violation. In the Pakistani legal system, as a general rule, liquidated damages require solid proof to demonstrate the actual loss incurred by the party seeking the damages.⁴⁵ Even a specific sum specified in a contract as liquidated damages cannot be retrieved unless the extent of the actual loss experienced is proven via appropriate proof.⁴⁶ In common-law nations, courts are hesitant to intervene if two parties engage in a contract and jointly decide a sum of actual pre-estimated losses (liquidated damages). In the

same instance, however, courts in Pakistan typically interfere between the parties by asking the claimant to show a breach of contract, in order to allow him to appropriate remuneration for the pre-estimated price. This different approach of Pakistani Courts from English Courts may be due to the non-availability of clear legislation on liquidated damages. Pakistani Courts themselves interpret Section 74 of the Contract Act of 1872 to deal with liquidated damages but on condition to prove breach of contract and loss suffered.

5. Role of Cap in Liquidated Damages Clause

As discussed above, parties to a commercial contract mutually determine the cap of liquidated damages at the time of execution of the contract, i.e., the maximum amount of damages that may be payable as liquidated damages. The parties may either stipulate the cap as a figure (i.e., PKR 20,000) or depict it as a percentage of the contract value (i.e., 10% of the contract's total value) payable on the breach. Such value or percentage stipulated serves as a limitation on the maximum amount of damages that may be claimable in the event of default.

Clause of liquidated damages should be clearly drafted to show the parties' intention that the cap of liquidated damages only applies to the liquidated damages, not to any general damages. In *Eco World-Ballymore Embassy Gardens Company Limited* case, the England and Wales High Court held:⁴⁷

In the commercial context of the contract, the parties' objective understanding of the provision was that it served two purposes: first, it provided for and quantified immediate liability for damages in the event of delay; and second, it limited Dobler's cumulative liability for project delays to a set percentage of the final contract price.

The parties intended to restrict Dobler's liability for delay damages. As a result, if the liquidated damages provision in Section 2.32.1 of the contract were void and unenforceable, contrary to my decision above, Eco World-Ballymore Embassy Gardens Company Ltd (EWB) would be allowed to claim general damages but subject to the overall liability cap of 7%. In *Crescendos Bionics Pvt Ltd* case, the Supreme Court of Singapore held that different concepts underpin "general damages" and "liquidated damages."⁴⁸ General damages aim to compensate the

aggrieved party for the losses incurred due to the breach. Liquidated damages, on the other hand, are designed to represent an accurate assessment of the potential losses that might occur in the case of a violation. There is no compelling reason to set a limit on general damages.

In light of the above judgments, the cap on liquidated damages played an essential role in commercial contracts. Clarifying the cap of the liquidated damages clause is very important to demonstrate that cap applies only to liquidated damages or general damages.

6. Conclusion

The liquidated damages clause gains importance in every commercial contract due to the development of jurisprudence. The impediments to proving actual damages in court can be time-consuming and costly. Parties mutually pre-estimate the loss for certain circumstances and provide for it in the agreement. The liquidated damages clause also plays a role in the contract's insurance. It gives a better understanding to the parties of their responsibilities in case of a violation/breach of the contract.

Furthermore, a clear and straightforward liquidated damages clause saves the parties from litigation; complex and confusing clauses favor those who breach the contract. Parties should determine the amount of the liquidated damages concerning the actual estimated loss of a particular breach or by reference to the financial status of the contract. Simply choosing an arbitrary figure which will not stand scrutiny at a later stage shall be futile as if the amount determined as liquidated damages is arbitrary; the courts are at liberty to declare the clause penal and render it ineffective. Therefore, courts usually decline to grant liquidated damages where the parties intend to create deterrence. Moreover, if the pleader is not sure that the court may consider the liquidated damages clause as a penalty, it would be safer for him/her to go for a claim of actual damages through the courts.

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