LIMITATIONS IN RECOVERING LIQUIDATED DAMAGES

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Before actually commencing with the construction of any work, the employer has to compile a number of documents concerning geological data of the proposed site, salient features of the construction work, detailed designs and drawings, technical specifications and other conditions of the contract so as to appraise the intending bidders of various factors which are like to affect his rates. Based on these documents, a detailed Notice Inviting Tenders containing the Bills of Quantities is also appended to enable the intending bidders to find out whether it would be feasible for him to execute the work within the time stipulated in the bid documents.

There are some works which are required to be completed much before the time normally allowed for execution of such like works because of extra ordinary urgency. In other works, the employer would permit normal time within which it is expected that the construction work would be completed. The time fixed in the contract documents is determined keeping in view quantum and magnitude of

work in terms of money, nature of building, covered area, number of storeys, specifications of the work and the like.

When the time during which the work has to be completed is provided in the contract, it is also provided therein that the contractor must achieve adequate progress in proportion to the time elapsed, e.g., the contractor shall achieve 1/8th of the amount of work in 1/4th of the time elapsed; 3/8th of the work in ½ of the time elapsed; 3/4th of the work in 3/4th of the time elapsed and the whole work within the scheduled time. It is also provided in the said clause that time shall be of the essence of the contract on the part of the contractor. It is also stipulated that in the event of the failure on the part of the contractor to achieve the required progress at various stages stated in the clause, the contractor shall render himself liable to pay liquidated damages. Normally the stipulation is that the contractor shall be liable to pay 1% of the estimated cost of the work put to tender for every week's delay subject, however, to a maximum of 10%.

WHETHER EMPLOYER CAN RECOVER LIQUIDATED DAMAGES WITHOUT DETERMINATION BY ARBITRATOR/COURT

The question whether the employer, without getting the matter adjudicated by an independent tribunal or Court, can recover the

amount on account of liquidated damages from the bill(s) of the contractor or from other sums due to him came up for consideration before a Division Bench of the Kerala High Court in *Rambal Co. Vs Kerala State Science and Technology Museum* (1). It was held that the employer would be well within its right to proceed to recover the amount by way of liquidated damages on account of breach of conditions of contract *if the contractor admits his breach but not when he disputes it*. It was further held that where the power of the State or its instrumentalities under an agreement entered into with an individual expressly provided for assessment of damages, that power cannot be exercised by the State or its instrumentality by its own officer, if the contractor disputes the allegation of breach of contract because none of the parties to the agreement can be an arbiter in its own cause. The aforesaid verdict of the Court was based upon the rule of law laid down by the Supreme Court in *State of Karnataka Vs Rameshwara Rice Mills* (2). The Apex Court held that a right to adjudicate upon an issue relating to a breach of contract cannot be said to flow from or is inherent in the right conferred to assess the damages arising from a breach of conditions. The power to assess damages is a subsidiary and consequential power and not the primary power. Even assuming that the terms of the relevant clause

affords scope for being construed as empowering the officer of the State to decide upon the question of breach as well as quantum of damages, the adjudication by the officer of the State Government regarding the breach of the contract cannot be sustained under the law because a party to the agreement cannot be an arbiter in his own cause. Interest of justice and equity require that where a party to a contract disputes the commission of any breach of contract, the adjudication should be by an independent person or body and not by the other party to the contract.

A Full Bench of the Kerala High Court in *Abdul Rahiman Vs Divisional Forest Officer* (3) held that when a dispute arises as to whether the contract has been broken or not, that dispute cannot be settled by one of the parties to the contract. The dispute may have to be referred to the arbitrator or the matter has to be settled in a Court of law. This principle also applies to the Government when it is a party to the contract.

In another decision of the same Court in *Latiheef Vs Superintending Engineer* (4) it was laid down that an order entailing civil consequences to an individual should be passed strictly in

accordance with the principles of natural justice. The State should not spring orders of this nature like a magician pulling rabbits out of his hat. A citizen cannot be suddenly confronted with a demand notice without there being a prior adjudication by a competent authority in accordance with the principles of natural justice and fairplay, both of which are intrinsic in the concept of equality before the law enshrined under Article 14 of the Constitution. To satisfy the fundamentals of fairplay in action the individual concerned should be given an opportunity of presenting his case before he is made liable and the adjudication in question has to be at the hands of an independent authority totally unconnected with the bargain. The question whether there is a breach, and if so, what is the quantum of damages etc. are all matters which are left to be adjudicated upon by a Court or Tribunal and not by one of the contracting parties. Adjudication of liability by one of the contracting parties as against the other contracting party and, that too, without proper notice and hearing resulting in heavy pecuniary liability to the latter is abhorrent to all notions of fairplay and justice and has been frowned upon by Courts.

LIQUIDATED DAMAGES NOT LEVIABLE IF EXTRA WORK ORDERED

When the contractor offers his tender, he does so on the premise that the quantities exhibited in the Bills of Quantities would be required to be executed in the stipulated period of the contract. He also presumes that the employer shall permit him to execute the work in a most economical manner and according to his programming and planning so as to achieve completion within the period fixed under the contract. If the contractor is required to undertake extra and additional works it would certainly stand the way of achieving completion within the original time. The contractor, therefore, cannot be subjected to financial liability in the form of liquidated damages if additional/extra work is required to be undertaken at site.

Chitty on Contracts 28th Edition (para 23.037, page 1157) states:-

> "Where, in a contract for the execution of specified works, it is provided that they shall be completed by a certain date, and that liquidated damages shall be payable by the contractor for non completion to time, the general rule is that the employer will be unable to recover such liquidated damages if he orders extra work to be done which necessarily delays completion of the work. However, the wording of the contract may be such that the original contract period continues to apply to the completion of the works even though additional work is ordered. Alternatively, the contract may provide that the agreed date for completion of the work shall be extended

> in the event that delay is caused by the additional work, in each case liquidated damages will be payable from the extended date if the works are not then completed."

In clause 12 of CPWD contracts, it is specified that if employer orders additional work over and above the scope of contract, time shall be extended in proportion to the quantum of extra work plus another extra period of 25% shall be added to such calculated time. It is thus, obvious that if the liquidated damages clause is to be operated upon by the employer, it can only be done when original time is extended by adding the time allowed for execution of the said extra work. In that view of the matter, unless the original time is displaced by a new date, the employer has no right whatsoever to levy liquidated damages.

TIME WHEN LIQUIDATED DAMAGES CAN BE LEVIED

At the outset it must be noted that realization of liquidated damages from the contractor by the employer must not be treated as a source of revenue because the very purpose for which the provision is made in the contract is to compensate the employer for legal injury sustained. Liquidated damages are nothing but a genuine pre-estimate of damages, which the employer suffers in consequence to the delay caused by the contractor. Thus, there can be no two

opinions that if the contractor due to his negligence, inefficiency, incapacity or the like fails to achieve completion, despite complete cooperation by the employer, he must be saddled with financial liability in the form of liquidated damages after observance of due formalities. Any haste shown in not following the principles of natural justice would be fatal to the cause of the employer.

Another case where completion is not achieved within the stipulated time may be when the delay is attributable both to the employer as well as to the contractor – the former not fulfilling its obligation by denying access to the whole or part of the site; failure to provide designs and drawings at the stage when these were required by the contractor; delay in giving timely instructions; failure to supply stipulated materials at the appropriate time; refusal or denial to pay due and legitimate payments; holding up huge amounts on account of non-sanctioning of rates of extra/substituted items or of rates of non-schedule items; failure to abide by the contractual duties etc. In such a situation, the employer loses the right to recover any amount by way of liquidated damages. If the delay is caused due to various acts of omission and commission on the part of the contractor coupled with factors causing incapacitation and impossibility by the employer

to proceed in the manner programmed and planned by the contractor, then it is doubtful if the employer can justify its act of levying liquidated damages on the contractor when the matter comes up before the arbitral tribunal/court.

The vital question is as to when the employer may exercise the power to levy liquidated damages – whether at the stages stipulated in the contract while the work is in progress or immediately after the work is completed or after elapse of reasonable period of time after the completion of the work. Depending upon the situation, the employer will determine as to what is best suited under the facts and circumstances of each case. However, the employer must ensure that there is no element of unreasonableness in dealing with the matter.

In practice what happens is that the employer defers the decision with regard to levying of liquidated damages for an abnormally long time after completion of work. At times, the action is initiated after more than 3 years of completion of the work or maybe still later when the contractor pressurizes the employer to settle the final bill. It is not an unknown fact that in government or semi-government organizations,

final bill is not settled for even 10 years after the completed work had been taken over by the employer and the building had been in use all along.

PERIOD WITHIN WHICH LIQUIDATED DAMAGES CAN BE LEVIED

The question that begs the answer is: From which date the period would start running against the employer for levying liquidated damages on the contractor? One school of thought is that the right to levy liquidated damages accrues to the employer when the contractor commits breach of the contract – whether during the original period or during the extended period of the contract. Another view is that it is only after the completion of the work that the employer would be in a position to ascertain as to the quantum of losses suffered in consequence of the delay occasioned due to defaults on the part of the contractor. Yet another view is that it is only at the time of finalization of accounts of the work when a right accrues to the employer to levy liquidated damages.

Before further discussion about the stage at which liquidated damages could be imposed on the contractor, it would be profitable to go through the usual clause attracting liquidated damages as also the

extension of time clause contained in the contract. For purposes of discussion, relevant clauses as contained in CPWD contracts may be referred to, which are as under:

> "Clause 2: The time allowed for carrying out the work as entered in the tender shall be strictly observed by the contractor and shall be deemed to be of the essence of the contract on the part of the contractor and shall be reckoned from the tenth day after the date on which the order to commence the work is issued to contractor. The work shall throughout the stipulated period of the contract be proceeded with all due diligence and the contractor shall pay as compensation an amount equal to one percent, or such smaller amount as the Superintending Engineer, (whose decision in writing shall be final) may decide on the amount of the estimated cost of the whole work as shown in the tender, for every day that the work remains uncommenced or unfinished, after the proper dates. And further, to ensure good progress during the execution of the work, the contractor shall be bound in all cases to complete one eighth of the whole of the work before one-fourth of the whole time allowed under the contract has elapsed; three-eighth of the work, before one half of such time has elapsed; and three-fourth of the work, before three-fourth of such time has elapsed. However, for special job, if a time schedule has been submitted by the contractor and the same has been accepted by the Engineer-in-charge, the contractor shall comply with the said time-schedule. In the event of the contractor failing to comply with the condition, he shall be liable to pay as compensation an amount equal to one percent or such smaller amount as the Superintending Engineer, (whose decision in writing shall be final) may decide on the said estimated cost of the whole work for every day that the due quantity of work remains incomplete; provided always that the entire amount of compensation to be paid under the provision of this Clause shall not exceed ten percent, on the estimated cost of the work as shown in the tender."

> “Clause 5: If the contractor shall desire an extension of the time for completion of the work on the grounds of his having been unavoidably hindered in its execution or any other ground, he shall apply in writing to the Engineer-in-charge within 30 days of the date of hindrance on account of which he desires such extension as aforesaid and the Engineer-in-charge shall, if in his opinion (which shall be final) reasonable grounds be shown thereof, authorise such extension of time if any, as may, in his opinion be necessary or proper.”

In case of justified delay on the part of the contractor in achieving completion, the employer extends the time for completion of the work with a right reserved for levying liquidated damages. A perusal of clause 5 would leave no manner of doubt that it operates independently and separately of the liquidated damages clause. While clause 2 of the CPWD agreements speaks of the progress that a contractor must achieve within the time fixed under the contract, it does not speak of the proportionate progress which the contractor must attain during the extended period of time. No reference whatsoever of extension of time clause is impliedly or expressly made in the liquidated damages clause. Obviously, therefore, the guiding factor for determining the period of limitation would be calculated keeping in view the stipulation of the liquidated damages clause.

Even though the cause of action for levying liquidated damages accrues to the employer at the intermediate stages defined in the contract, but the last cause of action accrues at the time when the original period under the contract expires. Thus, both in cases of termination of contracts as also in case of failure on the part of the contractor in completing the work in the original period of contract, right to levy liquidated damages can be exercised within a period of 3 years from the date when the contract was terminated or the stipulated date of completion, as the case may be. It can be argued that if reminders cannot keep the cause of action alive beyond a period of three years, so also the act of extending the time, from time to time, cannot keep the cause of action alive for more than 3 years beyond the stipulated date of completion. However, if extension of time clause is made a part of liquidated damages clause and rate of progress during the extended time is also specified, then the period of limitation of 3 years would be computed from the date when the last extension of time granted to the contractor expires.

LIQUIDATED DAMAGES NOT RECOVERABLE UNLESS LEGAL INJURY SUFFERED

Section 74 of the Indian Contract Act does not dispense with the basic condition of the breach resulting in any loss or damage that can

be called "legal injury". The party complaining of breach of contract and claiming compensation is entitled to succeed only on proof of “legal injury” having been sustained on account of such breach. Section 74 undoubtedly says that the aggrieved party is entitled to receive compensation from the party who has broken the contract, whether or not actual damage or loss is proved to have been caused by the breach. Thereby it merely dispenses with proof of “actual loss or damage”; it does not justify the award of compensation when in consequence of the breach no legal injury at all has resulted, because compensation for breach of contract can be awarded to make good 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. (5)

If on account of breach of contract, the complaining party has not suffered any loss, he is not entitled to any compensation whatsoever (6) even if a sum is named in the contract and is to be paid in the event of breach.(7) Where the Chief Engineer very categorically stated that on account of the delay on the part of the contractor in completing the work, there occasioned no loss to the Government, compensation cannot be granted by the courts even if a sum is

named in the contract as payable in the event of breach of contract.(8) Thus, compensation for delay caused in the completion of the work under a works contract will not be awarded in the absence of evidence to show that any loss was suffered consequent upon the delay.(9)

In *Michel Habib Raji Ayoub Vs Sheikh Suleiman El Taji El Forouquui* (10), it was observed as under:

> "Agreed liquidated damages, if to be enforced, must be the result of a 'genuine pre-estimate of damages' to use the illuminating phrase of LORD DUNEDIN. They do not include a sum fixed *in terrorem* covering breaches of contract of many varying degrees of importance the possible damages from which bear no relation to the fixed sum, which obviously have at no time been estimated by the contracting parties. It seems right, therefore, to conclude that now when the code is applied to contracts, 'damages' will be taken to mean actual damages, and the article will only apply to an agreement which represents a 'genuine pre-estimate of damages'. Where there is such an agreed sum 'no more and no less' can be awarded. But if the Court applying well-known rules has to conclude that the sum agreed was a penalty, whatever it may be called in the agreement, then the penal stipulation shall not be enforced."

LIST OF REFERENCES

1. 2000(3) Recent Arbitration Judgments 495
2. AIR 1987 SC 1359
3. AIR 1989 Ker 1
4. ILR 1993(2) Kerala 426
5. Fateh Chand Vs Balkishan Das, AIR 1963 SC 1405: (1964)1 SCR 515
6. Union of India Vs Rampur Distillery and Chemical Co. Ltd., AIR 1973 SC 1098; Satyanarayan Annolakchand Bhut Vs Vithal Narayan Jamdar, AIR 1959 Bom 452; Brahmayya Vs Teegala Gangaraju, AIR 1963 AP 310; Lakshmi Starch Factory Ltd. Vs Muhammad Ismail, 1968 Ker LT 713; State of U.P. Vs Chandra Gupta and Co., AIR 1977 All 28; Union of India Vs Raman Iron Foundary, AIR 1974 SC 1265
7. State of Rajasthan Vs Chandra Mohan Chopra, AIR 1971 Raj 229 : 1971 Raj LW 194 (DB)
8. State of Rajasthan Vs Chandra Mohan Chopra, supra
9. Namayya Vs Union of India, AIR 1958 AP 533
10. AIR 1941 PC 101: 196 IC 823