Unliquidated Damages: A burden or a duty of the aggrieved?

1. Introduction

In present times, a written contract plays a vital role in any business transaction. It not only establishes the basis of the relationship between the parties but also aims to protect their interest. When parties enter into a contract, the intention is to successfully perform the obligations stipulated but there is always an apprehension that one party may fail to fulfil any of its obligation(s). In such a situation, parties rely upon the dispute resolution clause which is undoubtedly one of the most germane clauses in a contract. To resolve any breach committed by a defaulting party different remedies are provided, damages being the most critical. Damages clause is not only a necessary deterrent but is also inserted with an aim to avoid breach. However, in case breach does occur, depending on the terms of the contract, the defaulting party would be liable to make good the loss suffered by the non-defaulting party.

Broadly there are two types of damages: liquidated, commonly called LDs and unliquidated. This newsletter aims to dive deeper into the concept of unliquidated damages with an emphasis on the legal framework surrounding the conditions to be satisfied in court before granting damages.

2. Legal Framework

In India, executed contracts are governed by the Contract Act, 1872 **("Act"),** which provides for consequences in case of breach. The Act stipulates that a non-defaulting party can claim for damages as a matter of right, provided certain conditions are fulfilled. The concept of LD is well recognized and similar across various jurisdictions. Briefly, under section 74 of the Act, these are contractually pre-agreed damages and payable on default by either one. Usually, parties pre-estimate the loss that one may incur in case of breach and stipulate the compensation amount in the contract. The idea is to limit the scope of the compensation to be granted under the contract. In case of dispute, the courts stick to the sums agreed by the parties. By contractually agreeing to a reasonable compensation amount, the parties safeguard their interest as there is a guarantee that compensation will be granted in case of a breach.

On the other hand, unliquidated damages are those which are not stipulated in a contract but the court quantifies them by assessing the *actual loss or injury* caused to a party. Section 73 of the Act is considered to be a bible with respect to these types of damages and a non-defaulting party can claim damages, not as a matter of right but subject to satisfying certain conditions. Section 73 provides

"When a contract has been broken, the party who suffers by such breach is entitled to receive, from the party who has broken the contract, compensation for any loss or damage caused to him thereby, which naturally arose in the usual course of things from such breach, or which the parties knew, when they made the contract, to be likely to result from the breach of it.

Such compensation is not to be given for any remote and indirect loss or damage sustained by reason of the breach."

A bare review of Section 73 gives an impression that it has an extremely wide scope of recovery for *any* loss or damage. The judiciary has been successful in narrowing down the scope of this section by reiterating the limitations prescribed in the section itself. Even though unliquidated

damages are not quantified in a contract but the non-defaulting party is entitled to them, once it can establish the loss incurred. In order to ensure a claim for unliquidated damages is successful, it is necessary to examine the statutory components and how the courts have dealt with them.

3. The Conditions

Once a contract is breached and an aggrieved party wants to seek legal recourse it has to be mindful of the conditions that it would have to fulfil in a claim for damages. The three most important considerations are that it should be in a position to establish that a contractual breach occurred, demonstrate a nexus of causation and substantiate, with strong evidence, proof of damages incurred.

3.1 *Breach of Contract:* Once a case is initiated, the judge(s) have to frame triable issues and, invariably, an issue is whether a breach was committed. While it is not necessarily a precondition, but an underlying assumption in any allegation of breach of contract is that a valid contract was in place. Else, the non-defaulting party can create a threshold issue of absence of a validly concluded contract between the parties. One such case is *Vedanta Limited v. Emirates Trading Agency LLC*[1] where the two lower courts, i.e., trial and High Court, failed to consider whether the contract was a concluded contract and decreed the suit in favour of the alleged non-defaulting party. The matter went up to the Supreme Court which had to determine whether the parties had a valid executed contract. After due deliberation, the court concluded that there was a simple proposal and counter proposal between the parties which did not fulfil the ingredients of a valid contract. The SC allowed the petition, set aside the orders of the lower courts, and held that the existence of a concluded contract is *sine qua non* in a claim for compensation for loss and damage under section 73 of the Act. In other words, a concluded and valid contract is absolutely necessary for allegation of breach and for any claim of damages to be successful.

It is quite common that all types of violations cannot be anticipated and provided in the contract though some modern-day contracts may contain descriptions of what qualifies as a material breach. Absent specific provisions on what constitutes breach or material breach, it is essential to rely upon common law principles, applied and expanded by jurisprudence. In order to determine whether a breach has been committed, the non-defaulting party has to prove, with substantial evidence, that the defaulting party failed to fulfil certain obligations stipulated in the contract. A simple allegation of breach will be insufficient and the court has to come to a clear finding, basis the record before it, that one party has defaulted in its contractual obligations. Without such a finding, the concept of damages becomes meaningless. In *State of Karnataka v. Shree Rameshwara Rice Mills*[2] the SC has held that adjudication upon the issue relating to breach of contract and adjudication of assessing damages arising out of the breach are two distinct concepts. In other words, merely deciding that there was a breach of contract will not entitle a non-defaulting party to recover damages as claimed. It is upon the non-defaulting party to prove the loss incurred.

3.2 *Causation:* In order to succeed in a claim for damages, there has to be a clear and unambiguous connection between the defaulting party's breach and the aggrieved party's loss. The latter has to prove before the court that the loss incurred was only due to the breach and there was no other external contributory factor. Simply put, the following three tests would help in assessing whether there is a direct connect between the breach and the loss incurred by the aggrieved party.

[1] AIR 2017 SC 2035
[2] 1987 (2) SCC 160

(i) Did a loss occur; **(ii)** Whether the loss suffered was caused by an event which the party in breach had no control over; and **(iii)** Whether the loss was predominantly caused by a breach of a duty of a third party, for whom the party in breach was not responsible?

3.3 *Proof of Damages:* When an aggrieved party claims damages basis breach of a contract, it has to demonstrate two important conditions, discussed below.

Firstly, it should have had already performed its obligations or that it was willing to perform its part of the contract. In other words, no person can succeed in a damages' claim due to breach of contractual obligations if the one seeking damages has not performed his part of the contract or does not intend to perform it. *Secondly,* it actually incurred loss for which it seeks damages and such loss must be proved,[3] and, in this regard, the quantum claimed should match the loss incurred. It has been observed in a number of judgments pertaining to unliquidated damages that such claims are often inflated, intentionally or unintentionally. The courts have observed that the most difficult question they deal with is the proper measure of damages as the amount claimed by a non-defaulting party and the amount they are entitled to could be very different. Therefore, an aggrieved party has to prove not only all the material facts, but the actual amount of damages sustained. Simply stating that there was a breach will not entitle a non-defaulting party to claim unliquidated damages. Further, as per settled law, there is no automatic liability to pay damages once breach is established, but, as noted before, loss suffered must be proved. Even where the aggrieved party fails to produce substantial evidence, it is the duty of the court to asses the damages based on the evidence and materials already before it.[4] The courts have relied upon the decision by the SC in *Union of India v. Raman Iron Foundry*[5] wherein it has been settled that:

> *9. .....Now the law is well settled that a claim for unliquidated damages does not give rise to a debt until the liability is adjudicated and damages assessed by a decree or order of a Court or other adjudicatory authority. When there is a breach of contract, the party who commits the breach does not eo instanti incur any pecuniary obligation, nor does the party complaining of the broach becomes entitled to a debt duo from the other party. The only right which the party aggrieved by the breach of the contract has is the right to sue for damages*."

From the foregoing, it is clear that the issue of breach has to be adjudicated upon, there has to be a clear finding that a breach occurred. And, the onus is on the claimant to prove its actual loss in court in order to assess the amount recoverable by the aggrieved party.

4. Other Important Considerations

Even though the scope of the concept of unliquidated damages is very wide, the adjudicating court shall also consider certain other crucial points, discussed below, in order to arrive at the quantum of damages recoverable by an aggrieved party.

4.1 *Remoteness of Damages:* Section 73 of the Act imposes certain limitations on claiming damages due to a breach. A non-defaulting party can only claim damages "*which naturally arose in the usual course of things from such breach*" and not remote damages. The key words being *naturally arose*, the objective is to ensure that the damages are granted for direct loss and not for any remote or indirect loss

[3] Maharashtra State Electricity Board v. Sterilite Industries (India) and Anr; AIR 2000 Bom 204
[4] AIR 1964 Pat 250
[5] Manu/SC/0005/1974

sustained by breach. The concept of remoteness of damage emerged from a leading English contract law case, Hadley v. Baxendale,[6] wherein it was held that *"where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally i.e. according to the usual course of things from such breach of contract itself, or such as may reasonably be supposed to have been in contemplation of both parties at the time they made the contract, as the probable result of it."* Following the trend laid down by Hadley, the Indian courts have held in numerous cases that a party suffering on account of the breach is entitled to recover only such loss or damage which arose directly and is not entitled to damages which can be said to be remote.[7] In the context of section 73 of the Act in order to determine whether the damages are too "remote," a test is whether the damage is such as must have been in the contemplation of parties as being a possible result of the breach. If yes, then it cannot be regarded as too remote.

4.2 *Mitigation of Loss:* Another duty imposed upon the aggrieved party is to minimize the loss incurred which has to be evaluated by the courts in order to arrive at the quantum of damages. It is an unspoken rule that one who seeks damages owes a duty of taking all reasonable steps to mitigate and, if he fails to do so, he cannot recover in respect of the damage he could have avoided. Thus, the principle of mitigation of loss ensures there is no automatic entitlement and a court has to carefully asses the efforts made in that regard. The SC has set out key principles in a number of judgments which provide that in case of breach the non-defaulting party shall be **(i)** restored as near as possible to the position in which he would have been had the contract been performed, **(ii)** under a statutory duty to take all reasonable steps to mitigate the loss consequent on the breach of contract and **(iii)** debarred from claiming damages to the extent he could have mitigated by taking reasonable steps.[8] The question whether a party has taken reasonable steps to mitigate the loss is not a question of law, but one of fact.

5. Conclusion

The conditions and considerations discussed above make it abundantly clear that only those claims for damages are successful which fulfil the mandate prescribed in section 73. A claim has to be supported with substantial evidence which might not always be available with the claimant. The burden of proof is completely on the aggrieved party to prove **(i)** the existence of a contract; **(ii)** occurrence of a breach which has been committed by the defaulting party; **(iii)** quantum of loss incurred; **(iv)** that it has performed or has always been ready to perform its part of the contract. Thereafter, to quantify the sum to be awarded, the court considers if the damages incurred are remote or not plus the efforts of the claimant to mitigate the loss. It is not easy to seek relief of damages for breach and the claimant has an extremely high onus to satisfy the court. It would not be incorrect to state that what started as a duty of the aggrieved party to prove in courts has increasingly become a burden and, therefore, it is crucial to be cognizant of the time and the degree of effort involved in ensuring a damages claim is successful. This means due caution has to be paid to the damages clause in a contract which should not be treated as boiler-plate, but parties should be aware of the long road ahead in the event of a breach.

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[6] 1854 (9) Exch. 341
[7] Herbicides (India) Ltd. v. Shashank Pesticides (P) Ltd. 2011 (180) DLT 243
[8] P. Radhakrishna Murthy v. NBCC Ltd. AIR 1962 SC 366