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Beyond the Old Rule: Should Cavendish Come to India?

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Arbitral tribunals are often faced with questions concerning the interpretation and enforcement of liquidated damages clauses; in such cases, the law governing the contract can significantly affect what damages can be claimed, the standard for proving such damages, and consequently the outcome of the dispute. This blog post examines the differences between English law and Indian law on liquidated damages to assist parties in determining which of the two may be most appropriate to govern their contracts. These differences may impact not only the choice of governing law in their agreement but perhaps even the seat of arbitration they choose.

In 1915, the House of Lords in *Dunlop Pneumatic Tyre v. New Garage & Motor Co. Ltd.* ("Dunlop"), found that for a liquidated damages clause to be enforceable, it must be a genuine pre-estimate of damages. In contrast, Indian law provides that where a contract contains a liquidated damages clause, a party suffering a breach of contract may receive "reasonable compensation" but acknowledges that if the clause stipulates an amount that is a genuine pre-estimate of damages, then this may be considered to be reasonable compensation.

However, in the recent case of *Cavendish Square Holdings BV v. Talal El Makdessi and ParkingEye Ltd. v. Beavis* ("Cavendish"), the United Kingdom Supreme Court ("UKSC") found that *Dunlop's* distinction between "genuine pre-estimate" and "penalty" was artificial and unsatisfactory. It found that merely because a provision was not a pre-estimate of loss, did not necessarily mean that it is penal. Rather, the true test was if the impugned provision was out of all proportion to the party's legitimate interest in the enforcement of the relevant obligation. Thus, one may argue that arbitral tribunals examining contracts governed by English law are more likely to enforce liquidated damages clauses than in contracts governed by Indian law, as the former's "disproportionality" standard is more liberal than the latter's "reasonableness" standard.

The Old Rule: Genuine Pre-Estimates and Reasonable Compensation

In *Dunlop*, the House of Lords examined if a clause requiring payment of £5 "by way of liquidated damages and not as a penalty" for each unit sold below the agreed-upon resale price was enforceable. It found that:

> *The essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-*

> *estimate of damage.*

It examined a number of criteria that may assist in evaluating if the damages were penal or not and accordingly found that the damages agreed upon were reasonable and thus were not a penalty.

Decades later, in *Fateh Chand v. Balkishan Das*, the Supreme Court of India ("SCI") examined a sale deed which provided that if the vendee failed to have the sale deed registered by a stipulated date, then the INR 1,000 of "earnest money" and INR 24,000 towards the sale price paid by the vendee, would be forfeited. The SCI noted the common law standard of "genuine pre-estimate of damages" and found that the INR 24,000 stipulation was "manifestly a stipulation by way of penalty". It found that under Section 74 of the Indian Contract Act if a liquidated damages clause is penal, the Court could provide reasonable compensation not exceeding the amount stipulated. It thus found that in addition to the earnest money, the vendor was entitled to retain compensation of INR 140 per month at a monthly interest of 6 percent till the date the breach was cured.

Subsequently, in *Maula Bux v. Union of India*, the SCI further added that if it is not able to ascertain reasonable compensation, the sum agreed upon by the parties – if it is a genuine pre-estimate of damages – can be considered as reasonable compensation, so long as it is not a penalty. Finally, in *Kailash Nath v. Delhi Development Authority*, the SCI found that a liquidated damages clause may be enforced as "reasonable compensation" only if it is a genuine pre-estimate of damages; in other cases, only reasonable compensation not exceeding the stipulated amount may be paid.

Thus, it may be argued that initially, a tribunal governed by Indian law and a tribunal governed by English law could reach similar conclusions on liquidated damages, due to the prevalence of the "genuine pre-estimate" condition in both, albeit with the caveat that if the clause did not stipulate a genuine pre-estimate, then an Indian law governed tribunal could award reasonable compensation. However, with *Cavendish*, this somewhat narrow divergence expanded substantially, as explained below.

Widening the Gap: The Effects of *Cavendish*

Cavendish was comprised of two appeals: *Cavendish Square Holding BV v. Talal El Makdessi*, and *ParkingEye Limited v. Beavis*. In *Cavendish v. Makdessi*, Makdessi had agreed to sell to Cavendish a controlling stake in a company. The agreement provided that on breach of certain restrictive covenants, Makdessi would not be entitled to receive the final two instalments of the price payable by Cavendish, and could be required to sell his remaining shares to Cavendish at a price which excluded the value of goodwill of the business. Makdessi breached these covenants but subsequently claimed that the clauses Cavendish sought to enforce were penalty clauses.

In *ParkingEye v. Beavis*, ParkingEye had been engaged to run a car park and had displayed signs in that park indicating that failure to comply with a two-hour time limit would result in a charge of £85. Beavis exceeded the time limit by nearly an hour, but upon ParkingEye's demand of the fine, argued that the £85 charge was an unenforceable penalty.

The UKSC called the penalty rule an "ancient, haphazardly constructed edifice which has not weathered well", and noted that "penalty" and "genuine pre-estimate of loss" are not natural

opposites or mutually exclusive; a clause that is not a pre-estimate is not necessarily penal, nor is a deterrent clause necessarily penal. The Court said:

> *The true test 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.*

In *Cavendish v. Makdessi*, the UKSC found that both impugned clauses were primary obligations not subject to the penalty rule. In contrast, in *ParkingEye v. Beavis*, the penalty rule was engaged, but the £85 charge was not a penalty, as ParkingEye had a legitimate interest in efficiently managing the parking spaces. The charge was also not extravagant or unconscionable. Accordingly, it did not violate the penalty rule.

Cavendish and Indian Law: *Dunlop* Stands Strong

Several recent Indian decisions have referred to *Cavendish*. In *Dishnet Wireless v. Union of India*[1], the Tripura High Court referred to *Cavendish* as establishing the "true principle" in respect of such clauses, but found that the "dominant test" in India was that of "[genuine] pre-estimate of reasonable compensation." In *Electronics Corporation of Tamil Nadu v. ICMC Limited*, the Madras High Court ("HC") had to adjudicate upon the imposition of liquidated damages due to a supplier's failure to adhere to a delivery schedule. The Madras HC, referring to Indian law, *Dunlop* and *Cavendish* found that there was "proportionality as between the extent of delay and the amount of liquidated damages", and thus it could be concluded that the liquidated damages clause reflected a genuine pre-estimate of loss. To a degree, this may indicate reliance on *Cavendish's* "proportionality" standard, though this may also be attributable to the Courts' freedom to determine reasonable compensation. Finally, in *LIC Housing Finance Ltd. v. Commissioner of ST*, the Custom, Excise and Service Tax Appellate Tribunal found that *Cavendish* clearly laid down the law on penalty clauses, but it did not substantively discuss how this affected Indian law on the subject. Accordingly, though *Cavendish* has been acknowledged in several Indian legal decisions, the Indian and English positions remain substantially different.

The Indian legal position essentially provides the arbitral tribunal with the power to award lower damages than those stipulated in the contract, if the liquidated damages clause are construed as penal. This may arguably diminish party autonomy and is likely to foment and prolong unnecessary disputes, as breaching parties may seek to diminish their liability from that stipulated in the liquidated damages clause to what the arbitral tribunal thinks is reasonable. In contrast, the *Cavendish* test strengthens party autonomy by narrowing the scope of intervention in liquidated damages clauses, and by ensuring that such clauses are more likely to be enforced (due to disproportionality being a more liberal standard than reasonableness or genuine pre-estimates) may diminish unnecessary disputes.

The importance of this choice of law is well demonstrated by investor-promoter disputes, in which investors often seek sweeping rights in the underlying agreements, to protect against breach and act as a safety net for the value of the investment. To that extent as *Cavendish* correctly identifies, every clause that may not be a genuine pre-estimate may also not be a penalty. Whether something

is a penalty or a commercially negotiated position to protect the interest of a party that has more monetary exposure, will have to be carefully examined on a case by case basis. It must also be noted that often, identifying what is a genuine pre-estimate of damages is very difficult, especially if there are multiple factors that contribute to such calculation. In such a case this standard does not apply. *Cavendish* provides a more commercially relevant standard for today's contracts, which Indian law ought to move towards.

Once attribution has been determined, it is often left to the arbitral tribunal to make the difficult decision on damages and quantification. Indian law provides a framework but may not always neatly assist when determining where a particular amount sits between a pre-estimate and a penalty. In that gap, it will do well for arbitral tribunals governed by Indian law to apply the *Cavendish* standard and move towards enforcing bargains. Such an evolution would also improve the perception of the Indian legal landscape as being reasonable and practical, as opposed to overly tied to the letter of old (and somewhat outdated) precedent.

The views expressed in this blog post are personal to the authors.

References

?1 (2016) 1 TLR 10

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