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## **REVISITING SECTION 74 OF THE INDIAN CONTRACT ACT, 1872: JUDICIAL INTERPRETATION OF PENALTY CLAUSES AFTER KAILASH NATH ASSOCIATES VS DDA**

### **ABSTRACT**

Section 74 of The Indian Contract Act, 1872 had combined penalty and liquidated damages and it had seemed to do away with the requirement of establishing loss, with the result that there was a limitation on compensation. There had been a split of judicial opinion for decades concerning whether there is an actual loss or whether damage must occur. The Supreme Court in *Kailash Nath Associates v. DDA* resolved the dispute, stating that the essential requirement of Section 74 was that there must be actual loss and the stipulated sum was a ceiling and not an automatic right. This paper problematises the doctrinal coherence, practicability and legislative goals of that decision. It aligns Section 73 and 74 under a compensation principle, but creates burdensome evidence requirements in complex infrastructure and commercial contracts where losses are often intangible, and causes government contracts or arbitration to be disrupted. The paper calls for legislative reform to ensure a proper balance between compensation and commercial certainty, suggesting a proportionality model, respecting a genuine pre-estimate, without the risk of an unforeseen forfeiture. In the absence of reform, *Kailash Nath* continues to be precedent, which requires careful loss documentation.

**Keywords:** Section 74, Indian Contract Act, 1872; penalty clauses; liquidated damages; *Kailash Nath Associates v. DDA*; actual loss; judicial interpretation; compensatory principle; burden of proof.

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## **I. INTRODUCTION**

The issue of 'Contractual Damages' in India falls somewhere in between the statutory laws and the principles derived from the common law. The Indian Contract Act, 1872, which was passed in the British India era was modelled upon the English contract law but contained important amendments, such as Section 74, which merged the two strands of the common law, penalty and liquidated damages, into a single provision. The traditional law in England in *Dunlop Pneumatic Tyre Co.*<sup>1</sup> held that such clauses involving extravagant sums were penalties unenforceable at law, and clauses providing for reasonable pre-estimates of loss were enforceable liquidated damages. It is argued that this dichotomy was apparently thrown out in section 74.

However, there is a proviso of noteworthy importance in the provision: 'Whether or not actual damage or loss by the breach has been sustained, a reasonable compensation not exceeding the amount so named shall be paid to the party suffering the breach from the party who has

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<sup>1</sup> *Dunlop Pneumatic Tyre Co. v. New Garage & Motor Co.* [2] [1915] AC 79

committed the breach...<sup>2</sup> For many years, the courts had different understandings of this language. One school had argued that proof of actual loss was not required; the courts only had to consider reasonableness to the cap, while another school had maintained that the amount of damage suffered did not have to equal the amount which the parties had stipulated, but that there did have to be some actual damage<sup>3</sup>.

The latter stance was clearly taken by the Supreme Court in the case of Kailash Nath Associates. The ruling has far-reaching implications for commercial contracts: parties who include provisions for penalties, forfeiture of earnest money and liquidated damages will no longer be able to rely on such provisions as automatic remedies, as they must now establish actual loss.<sup>4</sup> This paper questions the doctrinal correctness, workability, and intent of that holding in light of the intent of Section 74.

## **II. THE STATUTORY FRAMEWORK: SECTIONS 73 AND 74 OF THE INDIAN CONTRACT ACT, 1872**

Section 73 and Section 74 of the Act form a composite scheme for the award of compensation upon breach of contract.

### **A. SECTION 73: COMPENSATION FOR LOSS OR DAMAGE CAUSED BY BREACH**

Section 73 and Section 74 of the Act constitute a single scheme for the award of compensation when the contract is broken. Award for loss or damage due to breach of contract (Section 73): The party who is hurt by a breach of contract is entitled, from the other party, compensation for any loss or damage suffered by him as a direct result of the breach, which, naturally, is a loss or damage that has actually arisen in the ordinary course of the business or affairs of which the contract is a part, or that the parties at the time of the making of the contract knew or should have known to be likely to result from the breach<sup>5</sup>. The section also provides that remote or indirect loss which arises as a result of a breach is not recoverable. This is in line with the twin principles of remoteness, which was set out in the case of *Hadley v Baxendale*<sup>6</sup>.

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<sup>2</sup> Pollock & Mulla, *The Indian Contract and Specific Relief Acts*, 42–46 (R.Y. Deshmukh & Murlidhar Chaturvedi eds., 15th ed. 2017).

<sup>3</sup> Vikramaditya Khanna, *Contract Damages, Penalty Clauses and Efficient Breach*, 17 *NUJS L. Rev.* 55, 63–71 (2024).

<sup>4</sup> Avtar Singh, *Law of Contract and Specific Relief* 612–619 (13th ed. 2022).

<sup>5</sup> Nilima Bhadbhade, *Liquidated Damages and Penalty under Indian Contract Law*, 24 *Nat'l L. Sch. India Rev.* 77, 84–91 (2012).

<sup>6</sup> *Hadley v Baxendale*[4] (1854) 9 Exch 341.

The general rule is then that compensation will be awarded in accordance with the principles of remoteness and mitigation as in Section 73. It is in this context that it is important to consider Section 74.

## **B. SECTION 74: COMPENSATION FOR BREACH OF CONTRACT WHERE PENALTY STIPULATED**

Where a contract is broken and either a sum is named in the contract as the amount to be paid in case of such breach or there is in the contract any stipulation by way of a penalty, the party complaining of the breach is entitled to receive from the other party to the contract reasonable compensation not exceeding the amount so named or the sum of the penalty, as the case may be, though proof of actual damage or loss caused by the breach is not required<sup>7</sup>.

A further explanation to section 74 clarifies that a stipulation for greater interest from date of default shall be considered to be a stipulation by way of penalty. Particularly illustrative is case (b) in Section 74, where the contractor breaches a building contract, and the owner can only establish a nominal loss, for which he or she may obtain reasonable compensation, not necessarily the amount named in the contract<sup>8</sup>.

A key feature of the provision was that it removed the penalty/liquidated damages distinction which exists in English law; a second feature was that it capped the amount of recoverable compensation at the amount stipulated; and a third feature was that it, at least textually, eliminated the need for actual loss to be established, by the words 'whether or not actual damage or loss is proved to have been caused thereby'.

## **III. PRE-KAILASH NATH JURISPRUDENCE: A LANDSCAPE OF DIVERGENCE**

### **A. THE LIBERAL SCHOOL: NO PROOF OF LOSS REQUIRED**

There were several decisions by the Supreme Court and the High Courts that held that the words 'whether or not actual damage or loss is proved' was a full defence to make a loss. The plaintiff was only required to show: (a) that a sum was stipulated; and (b) that breach occurred. The test was a cap of reasonableness, not a test of reasonableness.

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<sup>7</sup> Shashank Garg, Understanding Liquidated Damages after *Kailash Nath Associates*, Mondaq (July 14, 2020), <https://www.mondaq.com/india/contracts-and-commercial-law/968412/understanding-liquidated-damages-after-kailash-nath-associates>.

<sup>8</sup> Fateh Chand v. Balkishan Dass, AIR 1963 SC 1405.

The Supreme Court had to consider the provisions of Section 74 in a context of earnest money and advance forfeiture in an agreement for the sale of immovable property in *Fateh Chand v. Balkishan Das*<sup>9</sup>. The Court ruled that courts may grant reasonable compensation for forfeiture of earnest money and that no evidence of actual damage is needed with a sum named. This ruling had been widely read as support for the dispensation thesis.

This principle of forfeiture of security deposit by the government was extended in the earlier Privy Council case of *Maula Bux v. Union of India*<sup>10</sup>, where it was held that where it is impossible or difficult to assess damages, the court may order the payment of a stipulated sum without requiring any further proof.

### **B. THE STRICT SCHOOL: PROOF OF ACTUAL LOSS IS NECESSARY**

As courts started to distinguish between the exactness of the loss requirement, which was relaxed by Section 74, and the showing of a loss, this opposite opinion began to prevail. This was discussed in the case of *Sir Chunilal V. Mehta And Sons, Ltd*<sup>11</sup>, wherein the Supreme Court had explained that even under Section 74, there must be some actual loss, with the aim of the Section being to give discretion to the court whether to award a reasonable amount of money, and not to fix an exact amount<sup>12</sup>.

In the case of *ONGC Ltd. v. Saw Pipes Ltd.*<sup>13</sup>, the liability to pay liquidated damages on the delay on delivery of goods has been considered by the three Judge bench. When the nature of the damage is difficult to establish, its loss, which is pre-estimated, can be recovered under Section 74. At times, this was read as the Court was not imposing the proof of loss requirement, but the Court did still require proof of probable or presumed loss or a proof that the contract was of a type where loss may be presumed.

The conflict between these authorities has existed for decades, and has left uncertainty in infrastructure contracts, real estate transactions, as well as government procurement, where huge liquidated damages clauses are indeed common<sup>14</sup>.

### **IV. KAILASH NATH ASSOCIATES v. DDA: THE DEFINITIVE RESTATEMENT**

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<sup>9</sup> *Fateh Chand v. Balkishan Das* AIR 1963 SC 1405.

<sup>10</sup> *Maula Bux v. Union of India* AIR 1970 SC 1955.

<sup>11</sup> *Sir Chunilal V. Mehta And Sons, Ltd v. The Century Spinning And Manufacturing Co., Ltd.* AIR 1962 SC 1314

<sup>12</sup> G.C.V. Subba Rao, *Law of Damages and Compensation* 287–295 (2d ed. 2019).

<sup>13</sup> *ONGC Ltd. v. Saw Pipes Ltd.* (2003) 5 SCC 705

<sup>14</sup> Anson's *Law of Contract* 589–594 (Jack Beatson et al. eds., 31st ed. 2020).

## **A. FACTS AND PROCEDURAL HISTORY**

The case of *Kailash Nath Associates v. DDA*<sup>15</sup> was in reference to the public auction conducted by Delhi Development Authority (“DDA”) for allotment of a commercial plot. The Appellant, Kailash Nath Associates was the highest bidder and paid 25% of the bid money as Earnest Money. Under the terms of the allotment letter, if the balance of the earnest money (75%) was not paid within the allotted time period, DDA had to forfeit all of the earnest money. The appellant challenged this forfeiture before the trial court who granted partial refund. However, the High Court had overruled it, holding that full forfeiture should be given. The Supreme Court was then asked to rule on the case<sup>16</sup>.

## **B. THE COURT'S ANALYSIS AND RATIO DECIDENDI**

The two-judge bench, presided over by Justice Ranjan Gogoi and Justice Rohinton Fali Nariman, had given a comprehensive verdict which: (i) explained the history of Section 74; (ii) consolidated the divergent verdicts of the two judges; and (iii) laid down a clear test<sup>17</sup>.

On the basis of proviso of Section 74, along with illustrations, it was imperative to demonstrate the actual loss/damage to the courts to a party who is complaining about breach so that it would be fair to grant any compensation to a party. The words ‘whether or not actual damage or loss is proved to have been caused’ do not negate the requirement of some actual loss, it simply means that if there is a loss then the court would be satisfied with reasonable compensation up to the ceiling specified and would not require a precise quantification of that loss. In previous cases, the Court's clear intent was to disallow the contrary reading.

The Court stated the principles that guided their decision were as follows:

**(i)** Where a sum is provided in the contract and/or there is a stipulation as a penalty, then Section 74 shall apply. If it is, the affected party can seek reasonable compensation, unlimited of the amount stated, without having to demonstrate any actual loss or damage (but only if it actually suffers any loss or damage).

**(ii)** If there is no loss suffered by the aggrieved, then they will only be entitled to nominal damages.

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<sup>15</sup> Ibid

<sup>16</sup> Rishabh Gupta, Reconsidering Section 74 after *Kailash Nath Associates*, 8 Indian J. Arb. L. 113, 120–29 (2019).

<sup>17</sup> Nishith Desai Assocs., Liquidated Damages and Penalty Clauses under Indian Law 7–15 (2021), <https://www.nishithdesai.com>.

(iii) The court shall consider all circumstances in determining reasonable compensation, and shall not be restricted to awarding such compensation in the amount stipulated.

(iv) The use of the word 'reasonable' in section 74, makes it clear that the court must be satisfied that the sum is likely to be a reasonable pre-estimate of likely loss; if a sum is indeed deemed to be extravagant and unconscionable, it may be reduced to a 'reasonable' amount<sup>18</sup>.

The Court had also ruled that it is the party making the claim for compensation who is responsible for proving the actual loss. DDA was unable to actually lose any of the allotment as a result of non-completion of the allotment and therefore, they were not entitled to forfeit the entire earnest money. This had then resulted in a partial refund being ordered<sup>19</sup>.

### **C. SIGNIFICANCE OF THE DECISION**

The ruling on Kailash Nath Associates was important on several fronts. For the first time, it witnessed the two sections (73 and 74) as an unified corpus of provisions, and both rooted in a notion of compensatory damages and not automatic or punitive. Secondly, it had brought Indian law into line with the House of Lords' approach in the case of Cavendish Square Holding BV v Talal El Makdessi<sup>20</sup>, which also disapproved of the use of purely penal clauses but allowed for legitimate pre-estimates. Thirdly, it had also affirmed the contracting parties and tribunals that penalty clauses are not automatic remedies.

### **V. POST-KAILASH NATH JUDICIAL DEVELOPMENTS**

#### **A. APPLICATION IN CONSTRUCTION AND INFRASTRUCTURE CONTRACTS**

The initial effects of the ruling of Kailash Nath Associates' were seen in the construction and infrastructure arena, where the payment for liquidated damages for delays was no longer a rarity. Additionally, in Bata India Ltd. vs. Suprabhat Construction<sup>21</sup>, the Delhi High Court had held that a contractor's liability, so far as delay damages are concerned, could not be pleaded without the owner producing evidence of the actual loss he suffered due to the delay.

Similarly, in the case of M/s Hindustan Steel Works Construction Ltd. v. C. Rajasekhar Rao<sup>22</sup>, the Calcutta High Court has relied on Kailash Nath Associates for setting aside the award of

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<sup>18</sup> Aditi Jha, Penalty Clauses and Proof of Actual Loss in Indian Contract Law, 5 NLUJ L. Rev. 149, 156–169 (2018).

<sup>19</sup> Chitty on Contracts ¶¶ 26-180 to 26-210, at 1834–59 (Hugh Beale ed., 34th ed. 2021).

<sup>20</sup> Cavendish Square Holding BV v Talal El Makdessi [12] [2015] UKSC 67

<sup>21</sup> Bata India Ltd. v. M/s Suprabhat Construction, Delhi High Court (O.S. No. 312/2016).

<sup>22</sup> M/s Hindustan Steel Works Construction Ltd. v. C. Rajasekhar Rao, Calcutta High Court (A.P.O. No. 174/2016).

liquidated damages in a public works contract, where the government has failed to prove any substantial prejudice caused by the delay or any downstream obligations.

## **B. ARBITRATION TRIBUNALS AND SECTION 74**

The ruling has caused much headache to arbitral tribunals under the Arbitration and Conciliation Act, 1996<sup>23</sup>. Common liquidated damages provisions for infrastructure contracts are 0.5% to 1% of the contract value for every week of delay. Post-*Kailash Nath*, tribunals increasingly require the employer to furnish financial records, correspondence, or expert testimony demonstrating actual loss.

In *National Highways Authority of India v. M/s Progressive-MVR (JV)*<sup>24</sup>, the Delhi High Court having set aside an arbitral award which awarded full liquidated damages for default in the construction of the road, faulted the arbitral tribunal for failing to turn its mind to the actual loss suffered as required by *Kailash Nath Associates*. The ruling shows its way into the field of supervisory review of Arbitral Awards.

## **C. EARNEST MONEY AND SECURITY DEPOSIT FORFEITURE**

The factual matrix of *Kailash Nath Associates* were about the forfeiture of earnest money and courts have had to intervene and decide the difference between a legitimate forfeiture clause and an unconscionable penalty. The Supreme Court had subsequently ruled that the forfeiture of the earnest money was not to be governed by Section 74 in the case of *Shree Hanuman Cotton Mills Ltd v Tata Aircraft Ltd*<sup>25</sup>, where it was a genuine security for breach. Since the removal of *Kailash Nath*, however, there has been a reconsideration of the need to properly frame forfeiture provisions despite the fact that they may be called 'earnest money' provisions<sup>26</sup>.

In the case of *M/s Vijay Infrastructure Ltd. v. Municipal Corporation of Greater Mumbai*<sup>27</sup>, the Bombay High Court had stated that if the contractor's earnest money is forfeited, it would be

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<sup>23</sup> Arbitration and Conciliation Act, 1996 (Act 26 of 1996), Section 34.

<sup>24</sup> *National Highways Authority of India v. M/s Progressive-MVR (JV)*, Delhi High Court (O.M.P. No. 438/2017).

<sup>25</sup> *Shree Hanuman Cotton Mills v. Tata Aircraft Ltd.*, AIR 1970 SC 1986

<sup>26</sup> Karan Gulati, Section 74 and the Judicial Shift toward Compensatory Principles, 14 NUJS L. Rev. 211, 225–237 (2022).

<sup>27</sup> *M/s Vijay Infrastructure Ltd. v. Municipal Corporation of Greater Mumbai*, Bombay High Court (A.O. No. 56/2018).

the responsibility of the Brihanmumbai Municipal Corporation to prove additional cost or prejudice, failing on which, they would be entitled to only nominal damages.

#### **D. EMPLOYMENT AND SERVICE CONTRACTS**

The provision has been used in the context of service contracts that require workers to work for at least a period of time, with penalties for those who leave early. In the case of *Sicpa India Ltd. v. Manas Pratim Dey*<sup>28</sup>, the Calcutta High Court, applying the rationale of *Kailash Nath Associates*, found that an employer alleging a service bond penalty has to establish actual losses suffered by the company in the event of the employee's departure, including loss of training, lost projects or cost of recruitment, etc., rather than just proving the breach of the service bond alone.

### **VI. COMPARATIVE JURISPRUDENCE: INTERNATIONAL PERSPECTIVES**

#### **A. ENGLISH LAW: THE MAKDESSI REFORMULATION**

In 2015, the penalty clause law got rethought almost at the same time in India and England. The Supreme Court in *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Ltd v Beavis*<sup>29</sup> abandoned the Dunlop test in favour of a new test which states that a clause is "penal" and therefore not enforceable if it does not represent any proportionate interest of the innocent party in enforcing the primary obligation. This added a wider angle on 'legitimate interest' than just compensation for losses.

This is in stark contrast to the Indian stance. Where there is a legitimate interest, the emphasis in English law shifted to greater enforcement of commercial penalty clauses, but in India *Kailash Nath Associates* took Indian law firmly towards the actual loss. Critics say that this separation will cause a disadvantage to the contracting parties in international contracts governed by Indian law, setting Indian penalty clauses at less commercial certainty<sup>30</sup>.

#### **B. AMERICAN LAW: THE RESTATEMENT APPROACH**

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<sup>28</sup> *Sicpa India Ltd. v. Manas Pratim Dey*, (2018) SCC OnLine Cal 1204, Calcutta High Court.

<sup>29</sup> *Cavendish Square Holding BV v. Talal El Makdessi; ParkingEye Ltd. v. Beavis*, [2015] UKSC 67 (per Lords Neuberger and Sumption).

<sup>30</sup> SCC Online Blog, *The Evolution of Liquidated Damages Jurisprudence after Kailash Nath Associates*, SCC Online Blog (Aug. 18, 2022), <https://www.sconline.com/blog>.

A provision that caps unreasonably large liquidated damages will be treated as a penalty and is therefore unenforceable under the Restatement (Second) of Contracts Section 356<sup>31</sup>. If the liquidated damages provisions satisfy the following requirements, then American courts will enforce them: (1) the actual damages were not reasonably calculated at the time the contract was formed; and (2) the amount does not exceed a reasonable prediction of any damages that would be incurred by the customer. This test is similar to the *ex ante* assessment approach, which emphasizes foreseeability at the formation of the contract, as compared with actual loss at breach, which is a slightly different test from the Indian inquiry.

### **C. UNIDROIT PRINCIPLES**

UNIDROIT Principles of International Commercial Contracts state in Article 7.4.13<sup>32</sup> that if a contract requires a sum to be paid on failure to perform, the aggrieved party have a right to receive that sum regardless of actual losses<sup>33</sup>. If it is grossly excessive in relation to the amount of harm caused, however, such sum may be reduced to a reasonable amount. The UNIDROIT approach, thus, applies the clause first, then judges can reduce it only in cases of "gross excess", which is a more respectful stance to contract autonomy than the one taken in *Kailash Nath Associates*<sup>34</sup>.

## **VII. CRITICAL ANALYSIS: DOCTRINAL STRENGTHS AND PRACTICAL CONCERNS**

### **A. DOCTRINAL COHERENCE**

The judgment in *Kailash Nath Associates* is a very doctrinally coherent judgment, as it brings into harmony the two provisions of Sections 73 and 74, where the compensatory principle is explicitly made the basis for both provisions. It would have added a punitive element to the scheme of the Act if Section 74 had given a right to recover the stipulated sum regardless of actual loss. Throughout its Chapter VI (sections 73 – 75), which focuses on restitution, the Act is aimed at bringing the aggrieved party back into the situation they were in before the contract was performed, rather than putting him into a better position than he was in before the performance.

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<sup>31</sup> Restatement (Second) of Contracts § 356(1) (Am. L. Inst. 1981).

<sup>32</sup> UNIDROIT Principles of International Commercial Contracts (2016), Article 7.4.13.

<sup>33</sup> Ewan McKendrick, *Contract Law* 934–948 (14th ed. 2021).

<sup>34</sup> G.H. Treitel, *The Law of Contract* 1087–1102 (14th ed. 2015).

Further, the Court's interpretation is corroborated by the Explanation and illustrations to Section 74. Illustration (a): If a party is entitled to 'reasonable compensation', not the stipulated compensation. In illustration (b) it is expressly assumed that there may be a decrease from the amount so stated, but no loss is made out. The illustrations which make up the context to the legislative text of Section 3 of the General Clauses Act, 1897<sup>35</sup> make it abundantly clear that the imposed sum is not a minimum, but a maximum.

## **B. THE BURDEN OF PROOF CHALLENGE**

The ruling is doctrinally correct, but poses practical problems in terms of burden of proof. Actual loss caused by contractor delay in the context of a long-term infrastructure contract often is unfocused and intangible. The reputational damage, political costs or cascading delays in dependent projects that may be incurred by government employers are all real, but hard-to-numerate losses. Such requirements would impose an undue onus upon those parties that specifically included liquidated damages clause to avoid quantification exercises<sup>36</sup>.

A part of this concern is taken care of in *ONGC v. Saw Pipes*<sup>37</sup> and in this case, the Court observed that if the proof of exact loss would be “patently difficult”, then the prescribed sum could be treated as a reasonable pre-estimate. There's speculation whether this carve-out will remain intact at *Kailash Nath Associates*. The more prudent interpretation of the post-*Kailash Nath* law is that there must be a clear loss, of a tangible nature at least or a loss to be presumed, but that the actual amount of loss does not need to be determined<sup>38</sup>.

## **C. IMPACT ON STANDARD-FORM GOVERNMENT CONTRACTS**

Many other commercial contracts in India, especially government contracts in various standard-form documents issued by the Central Public Works Department, the National Highways Authority of India, and public-sector undertakings, contain liquidated damages clauses that are based on a percentage of the contract value. Both of these clauses are negotiated ex ante as reasonable commercial allocations of the delay risk.

The requirement of actual loss proof by the *Kailash Nath Associates* could be a disincentive to contracting companies which believe the state is unlikely to be able to measure the loss

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<sup>35</sup> The General Clauses Act, No. 10 of 1897, § 3 (India).

<sup>36</sup> Anirudh Krishnan, *Revisiting Penalty Clauses under Indian Contract Law*, 27 Nat'l L. Sch. India Rev. 93, 101–114 (2015).

<sup>37</sup> *Ibid*

<sup>38</sup> Cyril Amarchand Mangaldas, *Understanding the Supreme Court's Decision in Kailash Nath Associates* 6–18 (2016), <https://www.cyrilshroff.com>.

accurately. It also places a heavy load on the judicial and arbitral mechanisms with the provision of detailed evidentiary hearings on loss, whereas the parties meant to preclude just such an issue with the liquidated damages provision.

#### **D. THE 'GENUINE PRE-ESTIMATE' DOCTRINE AND ITS FUTURE**

Section 74, as reinterpreted, still allows for the concept of 'genuine pre-estimate' in a limited fashion: if at the time of contracting either party had thought of the class of loss that would be hard to prove after breach (for example, reputational damage, loss of goodwill, or exposure to regulatory penalties), then the agreed sum may be a substitute for that loss, and the court may award it without complicated evidence. This method does not change what was earlier decided in *Fateh Chand*<sup>39</sup> and was not affected by the decision in *Kailash Nath Associates*, and offers a cushion to parties who are at the market end of writing meticulously drafted penalty clauses.

#### **VIII. THE CASE FOR LEGISLATIVE REFORM**

Judicially coherent at this doctrinal stage, there is a recurring mismatch between the legislative text and commercial practice that needs to be seriously considered in the legislation. The Law Commission of India pointed out the inadequacy in section 74 in its 13th Report (1958) which suggested clarity on the relationship between the stipulated sum and actual loss. Although there have been a number of later reports on the Indian Contract Act, 1872 in its entirety, none have been specific to Section 74. More than 60 years later, when the number of infrastructure contracts, PPPs, and cross-border commerce has grown exponentially, the need for change is even more pressing now.

Parliament should introduce a proviso which explicitly acknowledges 'genuine pre-estimate clauses', which are provisions that are negotiated arm's length between commercial parties who have equal bargaining power where actual loss is hard to establish following breach, first. Such provisions should be binding without the necessity of any proof of damage after the breach, other than a gross disproportionality test. Indian law would then be consistent with the "legitimate interest" standard recently introduced in *Cavendish Square Holding BV v Makdessi*<sup>40</sup> and the UNIDROIT Principles of International Commercial Contracts that provides for a similar test.

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<sup>39</sup> *Ibid*

<sup>40</sup> *Cavendish Square Holding BV v Makdessi* [2015] UKSC 67

Second, there needs to be a sub-clause in the sector for construction, infrastructure, energy and technology contracts, which have a definite delay loss, but is inherently diffuse and probabilistic<sup>41</sup>. If the liquidated damages rate is certified by an independent engineer/expert at the time the contract is formed, then it creates a rebuttable presumption of reasonableness, which creates the burden of displacing the rate on the party in breach, not the employer<sup>42, 43</sup>. This is in keeping with the rule that "a man cannot benefit from his own wrong.

Third, the amendment should introduce and enscribe an objective "proportionality standard" as to whether a court or arbitral tribunal may or may not reduce a penalty clause; that is, a court or arbitral tribunal may reduce the penalty only after presentation of evidence of the highest possible loss which can reasonably be regarded as having been caused by the breach<sup>44</sup>. This is more restrictive than the current loosely-worded "reasonableness" test, which leaves an arbitrator's decisions subject to more uncertainty.

Last, the exception for consumer contracts and inequality of bargaining power on adhesion contracts should be preserved and courts should always be given the discretion to deem penalty clauses to be "unconscionable"<sup>45</sup>. A distinction between commercial and consumer contexts would harmonise contractual autonomy with fair protection, lower down satellite litigation<sup>46</sup> and would certainly significantly bolster the position of India as a preferred seat for international commercial arbitration.

## IX. CONCLUSION

Section 74 of Indian Contract Act, 1872 has a pivotal role in the law of damages for the breach of contract. The Supreme Court in *Kailash Nath Associates v. DDA* has laid down a hundred years of judicial uncertainty by clearly holding that Section 74 requires the occurrence of the loss and that the stipulated sum is merely meant to cap the compensation claim and not be an automatic right. The decision is rooted in doctrine and in the plain meaning of the provision, as well as the "compensatory architecture of the Act.

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<sup>41</sup> *Azimut-Benetti SPA v. Healey*, [2010] EWHC (Comm) 2234, [46]–[59] (Eng.).

<sup>42</sup> Law Comm'n of India, *Thirteenth Report on the Indian Contract Act, 1872*, ¶¶ 107–112, at 54–58 (1958).

<sup>43</sup> G.C. Cheshire, C.H.S. Fifoot & M.P. Furmston, *Law of Contract* 785–809 (17th ed. 2017).

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Still, the decision brings the following practical issues: it could be an unfair disadvantage on parties who have properly agreed to pay pre-estimated damages; it imposes evidentiary obligations which could be disproportionately burdensome in long-duration and complex contracts; and it departs from recent international jurisprudence, especially the UK Supreme Court's Makdessi framework, which could impact India's competitiveness in cross-border commerce.

The courts have answered some such concerns by introducing the 'genuine pre-estimate' carve-out and the 'difficult to prove' carve-out, as well as acknowledging that proof of loss does not have to be exact. It is up to the legislature to reconsider Section 74 in light of the principle of proportionality and to establish an explicit framework that gives effect to it, while safeguarding the contractual autonomy of both parties and avoiding unconscionable forfeiture. Until that change occurs, the decision in *Kailash Nath Associates* remains all the authorities have to say on Indian law and practitioners need to advise clients to ensure that penalty clauses have the proper accompanying contemporised records, showing the loss on which the clause would be based.

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