Levy of Liquidated Damages and Risk-cost execution of work

In a recent decision reported as *J.G. Engineers Private Limited v. Union of India*, (2011) 5 SCC 758, the Hon'ble Supreme Court has delivered a landmark judgment, which will go a long way in minimizing the problems of contractors. Heretofore, the matter with regard to dispute regarding liquidated damages was not open to adjudication before an arbitral tribunal because of the opening words in standard form arbitration clauses: "Except where otherwise provided….". The Supreme Court had earlier in a matter reported as *Vishwa Nath Sood v. Union of India*, AIR 1989 SC 952 had held that such matters on which the decision of an authority was final and binding could not be adjudicated upon in arbitration.

On the basis of the said judgment, for as long as 21 years the contractors had been denied recourse to arbitration when it came to claim for liquidated damages. The only course open to the contractor in such a case was to file a suit in a court of law claiming money since realized from him by way of liquidated damages by the employer. In many cases, contractors would not even think of going to the court to file a suit against the employer and those who knocked at the door of the court sometimes got relief while on other occasions failed to get relief since the matter involved concerned technical issues and courts could not properly appreciate the same. Now when the same matter is under the consideration of those arbitral tribunal which are aware of the technicalities of the matter involved, they would be able to do justice to the parties, taking into consideration the ground realities.

The standard clause in works contracts provided for levy of liquidated damages as well as rescinding the contract and getting the work executed at the risk and cost of the contractor and the same read as follows:

> ***"Clause (2)***
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> "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 essence of the contract and shall be reckoned from the tenth day after the date on which the order to commence the work is issued to the 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 per cent 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 in which the time allowed for any work exceeds one month (save for

special jobs) to complete one-eighth of the whole of the work before one-fourth of the whole time allowed under the contract has elapsed, three-eighths of the works before one-half of such time has elapsed and three-fourths of the work before three-fourths of such time has elapsed. However for special jobs 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 this condition, he shall be liable to pay as compensation an *amount equal to one per cent or such small 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 provisions of this clause shall not exceed ten per cent, on the estimated cost of the work as shown in the tender."

"Clause (3)

"The Engineer-in-charge may without prejudice to his right against the contractor in respect of any delay or inferior workmanship or otherwise or to any claims for damage in respect of any breaches of the contract and without prejudice to any rights or remedies under any of the provisions of this contract or otherwise and whether the date of completion has or has not elapsed by notice in writing absolutely determine the contract in any of the following cases:

(*i*) If the contractor having been given by the Engineer-in-charge a notice in writing to rectify, reconstruct or replace any defective work or that the work is being performed in any inefficient or other improper or unworkmanlike manner, shall omit to comply with the requirements of such notice for a period of seven days thereafter or if the contractor shall delay or suspend the execution of the work so that either *in the judgment of the Engineer-in-charge (whose decision shall be final and binding) he will be unable to secure completion of the work by the date of completion* or he has already failed to complete the work by that date….

(*ii*) (not relevant)

(*iii*) If the contractor commits breach of any of the terms and conditions of this contract.

(*iv*) If the contractor commits any acts mentioned in Clause (21) hereof.

When the contractor has made himself liable for action under any of the cases aforesaid, the Engineer-in-charge on behalf of the President of India shall have powers:

(*a*) To determine or rescind the contract as aforesaid (of which termination or rescission notice in writing to the contractor under the hand of the Engineer-in-charge shall be conclusive evidence) upon such determination or rescission the security deposit of the contractor shall be liable to be forfeited and shall be absolutely at the disposal of the Government.

(*b*) (not relevant)

(*c*) After giving notice to the contractor to measure up the work of the contractor and to take such part thereof as shall be unexecuted out of his hands and to give it to another contractor to complete in which case any expenses which may be incurred in excess of the sum which would have been paid to the original contractor if the whole work had been executed by him (*of the amount of which excess the certificate in writing of the Engineer-in-charge shall be final and conclusive*) shall be borne and paid by the original contractor and may be deducted from any money due to him by the Government under this contract or on any other account whatsoever or from his security deposit or the proceeds of sales thereof or a sufficient part thereof as the case may be."

From the foregoing it would be clear that the Engineer-in-charge had been given an unfettered power by the contract to take action against the contractor in the event the work being delayed beyond what had been agreed to between the parties. In certain cases, milestones had been fixed and the contractor was also made liable to pay the liquidated damages in the event of failure to achieve the agreed milestones.

In many cases, contractors had been representing that the work had got delayed not on account of any factors attributable to him but on account of failure on the part of the employer to fulfill its obligations as enshrined in the contract agreement between the parties. It is worth mentioning that no Engineer-in-charge would own responsibility for fear of being held accountable by the higher authorities. In fact, there would be objections from the Audit as well as from the higher authorities as to why the Engineer-in-charge failed to levy liquidated damages when the work could not be executed in terms of the contract.

The question of rescinding the contract was another important point which called for urgent attention of the Engineer-in-charge. Rescinding of contract should be the last resort because it is very seldom that the employer is able to realize the risk-cost expense involved. It is for this reason that the CPWD has omitted from the contract, clause relating to risk and cost. However, CPWD invokes the bank guarantees available with it in the form of security deposit and performance guarantee.

The Supreme Court interpreted Clauses 2 and 3 as under:

> **"**Clauses (2) and (3) of the contract relied upon by the respondents no doubt make certain decisions by the Superintending Engineer and Engineer-in-charge final/final and binding/final and conclusive, in regard to certain matters. But the question is whether Clauses (2) and (3) of the agreement stipulate that the decision of any authority is final in regard to the responsibility for the delay in execution and consequential breach and therefore exclude those issues from being the subject-matter of arbitration. We will refer to and analyse each of the "excepted matters" in Clauses (2) and (3) of the agreement to find their true scope and ambit:
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> "(*i*) Clause (2) provides that if the work remains uncommenced or unfinished after proper dates, the contractor shall pay as compensation for every day's delay an amount equal to 1% or such small amount as the Superintending Engineer (whose decision in writing shall be final) may decide on the estimated cost of the whole work as shown in the tender. *What is made final is only the decision of the Superintending Engineer in regard to the percentage of compensation payable by the contractor for every day's delay, that is, whether it should be 1% or lesser. His decision is not made final in regard to the question as to why the work was not commenced on the due date or remained unfinished by the due date of completion and who was responsible for such delay*.
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> "(*ii*) Clause (2) also provides that if the contractor fails to ensure progress as per the time schedule submitted by the contractor, he shall be liable to pay as compensation an amount equal to 1% or such smaller amount as the Superintending Engineer (whose decision in writing shall be final) may decide on the estimated cost of the whole work for every day the due quantity of the work remains incomplete, subject to a ceiling of ten per cent. *This provision makes the decision of the Superintending Engineer final only in regard to the percentage of compensation (that is, the quantum) to be levied*

and not on the question as to whether the contractor had failed to complete the work or the portion of the work within the agreed time schedule, whether the contractor was prevented by any reasons beyond its control or by the acts or omissions of the respondents, and who is responsible for the delay.

"(*iii*) The first part of Clause (3) provides that if the contractor delays or suspends the execution of the work so that either in the judgment of the Engineer-in-charge (which shall be final and binding), he will be unable to secure the completion of the work by the date of completion or he has already failed to complete the work by that date, certain consequences as stated therein, will follow. *What is made final by this provision is the decision of the Engineer-in-charge as to whether the contractor will be able to secure the completion of the work by the due date of completion, which could lead to the termination of the contract or other consequences. The question whether such failure to complete the work was due to reasons for which the contractor was responsible or the Department was responsible, or the question whether the contractor was justified in suspending the execution of the work, are not matters in regard to which the decision of the Engineer-in-charge is made final*.

"(*iv*) The second part of Clause (3) of the agreement provides that where the contractor had made himself liable for action as stated in the first part of that clause, the Engineer-in-charge shall have powers to determine or rescind the contract and the notice in writing to the contractor under the hand of the Engineer-in-charge shall be conclusive evidence of such termination or rescission. *This does not make the decision of the Engineer-in-charge as to the validity of determination or rescission, valid or final. In fact it does not make any decision of the Engineer-in-charge final at all. It only provides that if a notice of termination or rescission is issued by the Engineer-in-charge under his signature, it shall be conclusive evidence of the fact that the contract has been rescinded or determined*.

"(*v*) After determination or rescission of the contract, if the Engineer-in-charge entrusts the unexecuted part of the work to another contractor, for completion, and any expense is incurred in excess of the sum which would have been paid to the original contractor if the whole work had been executed by him, the decision in writing of the Engineer-in-charge in regard to such excess shall be final and conclusive, shall be borne and paid by the original contractor. *What is made final is the actual calculation of the difference or the excess,*

that is, if the value of the unexecuted work as per the contract with the original contractor was Rs. 1 lakh and the cost of getting it executed by an alternative contractor was Rs. 1,50,000 what is made final is the certificate in writing issued by the Engineer-in-charge that Rs. 50,000 is the excess cost. The question whether the determination or rescission of the contractor by the Engineer-in-charge is valid and legal and whether it was due to any breach on the part of the contractor, or whether the contractor could be made liable to pay such excess, are not issues on which the decision of Engineer-in-charge is made final.

"Thus what is made final and conclusive by Clauses (2) and (3) of the agreement, is not the decision of any authority on the issue whether the contractor was responsible for the delay or the Department was responsible for the delay or on the question whether termination/rescission is valid or illegal. What is made final, is the decisions on consequential issues relating to quantification, if there is no dispute as to who committed breach. That is, if the contractor admits that he is in breach, or if the arbitrator finds that the contractor is in breach by being responsible for the delay, the decision of the Superintending Engineer will be final in regard to two issues. The first is the percentage (whether it should be 1% or less) of the value of the work that is to be levied as liquidated damages per day. The second is the determination of the actual excess cost in getting the work completed through an alternative agency. The decision as to who is responsible for the delay in execution and who committed breach is not made subject to any decision of the respondents or its officers, nor excepted from arbitration under any provision of the contract.

"In fact the question whether the other party committed breach cannot be decided by the party alleging breach. A contract cannot provide that one party will be the arbiter to decide whether he committed breach or the other party committed breach. That question can only be decided by only an adjudicatory forum, that is, a court or an Arbitral Tribunal."

It was also held by the Hon'ble Supreme Court that if the contractor was not at fault or contributing towards the delay and the delay had occurred only on account of omissions and commissions on the part of the employer, then the provisions which make the decision of the Engineer-in-Charge final and conclusive would be irrelevant. Thus, the arbitrator has been vested with the

power to try and decide all the claims of the contractor as well as that of the Employer.

It was also held by the Hon'ble Supreme Court that after having granted extension of time without levy of liquidated damages, the Engineer-in-charge looses the right to levy liquidated damages for that period for which extension had already been given.

As per the dictum of the Supreme Court, once the arbitrator records a finding on the basis of material available before him that the contractor was not responsible for the delay and that the termination was wrong, then it would be the employer who would be liable for the consequences arising out of wrongful termination of contract. Therefore, all the claims which the Employer might have filed before the arbitrator would not be awarded in its favour.