

Contractual Damages in Arbitration: Compensation, Not Punishment

Shashank Manish, Nidhi Sahay and Shubham Ranjan¹

ABSTRACT

Contractual damages occupy a central position in commercial arbitration, particularly where disputes arise from delay, non-performance, loss of profits, additional expenditure, prolongation costs, and other consequences of contractual breach. Under Sections 73 and 74 of the Indian Contract Act, 1872, the fundamental principle governing such claims is that damages are compensatory rather than punitive. This paper examines the application of this principle to claims for actual and liquidated damages in arbitral proceedings. It analyses the development of Indian law through *Fateh Chand v. Balkishan Das*, *Maula Bux v. Union of India*, *ONGC Ltd. v. Saw Pipes Ltd.*, *Kailash Nath Associates v. Delhi Development Authority*, and *Construction & Design Services v. Delhi Development Authority*, culminating in the Supreme Court's recent decision in *Saisudhir Energy Ltd. v. NTPC Vidyut Vyapar Nigam Ltd.*

The paper focuses particularly on the relationship between proof of actual loss, genuine pre-estimation of damages, reasonable compensation, commercial certainty, and the prohibition against punitive awards. It further examines the evidentiary difficulties that arise where loss is inherently difficult to quantify, including in public infrastructure and public-utility projects. In the arbitration context, the paper considers how these substantive principles interact with the tribunal's duty to apply Indian law and with the limited scope of judicial scrutiny of arbitral awards. The paper argues that Section 74 should not be understood as either imposing an absolute requirement of mathematical proof of loss or permitting automatic enforcement of a stipulated contractual sum. Instead, the provision requires a context-sensitive determination of reasonable compensation, balancing contractual autonomy and commercial certainty against the fundamental prohibition on awarding damages that operate as punishment.

¹ The Authors are Advocates at the Hon'ble Supreme Court of India, New Delhi.

KEYWORDS

Contractual Damages; Liquidated Damages; Penalty; Reasonable Compensation; Section 73; Section 74; Indian Contract Act, 1872; Arbitration; Proof of Loss; Commercial Certainty; Public Utility Contracts; Arbitral Awards

INTRODUCTION

A breach of contract does not, by itself, entitle the innocent party to a windfall. This simple proposition lies at the heart of the law of damages.² In commercial arbitration, claims for damages often form a substantial part of the amount in dispute. A claimant may seek loss of profits, additional expenditure, prolongation costs, loss of business, price escalation or other consequential losses.³ Separately, the contract itself may provide for “liquidated damages” at a fixed amount or percentage in the event of delay or some other breach.⁴

The difficulty arises when the distinction between compensation and punishment becomes blurred. The law under Sections 73 and 74 of the Indian Contract Act, 1872 proceeds on a fundamentally compensatory principle.⁵ Money is awarded to compensate a party for the consequence of a breach. It is not awarded merely because the other party committed a breach, nor is it intended to punish the party in default.⁶

This distinction assumes particular importance before an arbitral tribunal. The tribunal derives its authority from the contract, but it must award damages in accordance with the substantive law of India.⁷ A contractual clause cannot, merely by using the expression “liquidated damages”, convert a punitive demand into lawful compensation.⁸

² Indian Contract Act, 1872, No. 9 of 1872, §§ 73–74 (India); *Fateh Chand v. Balkishan Das*, AIR 1963 SC 1405, 1409–10 (India).

³ Indian Contract Act, 1872, No. 9 of 1872, § 73 (India).

⁴ Indian Contract Act, 1872, No. 9 of 1872, § 74 (India); *ONGC Ltd. v. Saw Pipes Ltd.*, (2003) 5 SCC 705, 716–17 (India).

⁵ Indian Contract Act, 1872, No. 9 of 1872, §§ 73–74 (India); *Fateh Chand v. Balkishan Das*, AIR 1963 SC 1405, 1409–10 (India).

⁶ *Fateh Chand v. Balkishan Das*, AIR 1963 SC 1405, 1409–10 (India); *Kailash Nath Assocs. v. Delhi Dev. Auth.*, (2015) 4 SCC 136, 150–51 (India).

⁷ Arbitration & Conciliation Act, 1996, No. 26 of 1996, § 28(1)(a) (India).

⁸ *Fateh Chand v. Balkishan Das*, AIR 1963 SC 1405, 1409–10 (India); *ONGC Ltd. v. Saw Pipes Ltd.*, (2003) 5 SCC 705, 716–18 (India).

SECTION 73: THE STARTING POINT IS THE LOSS

Section 73 contains the general rule governing compensation for breach of contract. Where a contract has been broken, the party suffering from the breach is entitled to compensation for loss or damage which naturally arose in the usual course of things from the breach, or which the parties knew, when entering into the contract, was likely to result from such breach. At the same time, remote and indirect loss is excluded.⁹

The underlying idea is straightforward. The object of damages is, so far as money can do so, to compensate the innocent party for the consequences of the breach.¹⁰ Damages are not intended to place that party in a better position merely because a breach has occurred.¹¹ This also explains why a claim for “actual damages” requires more than proof of breach.

There is an important difference between proving that a contract was breached and proving that the breach caused a particular monetary loss. A claimant seeking actual damages must ordinarily establish the breach, the loss suffered, the causal connection between the two, the reasonable foreseeability of the loss and, where relevant, the steps taken to mitigate that loss.

For example, if a contractor delays completion by six months, the employer cannot simply state that the contractor was in delay and therefore claim an arbitrary sum of money. The employer must ordinarily demonstrate what financial consequence flowed from that delay: additional supervision costs, additional rent, financing costs, loss of revenue, cost of engaging another contractor, or some other legally recoverable loss. The breach creates the cause of action. It does not automatically prove the quantum of damages.

This distinction is sometimes lost in arbitration proceedings, particularly where very large amounts are claimed under broad heads such as “business loss”, “loss of opportunity” or “loss of profits”. The amount claimed must ultimately have a rational and evidentiary connection with the breach.

SECTION 74: WHAT CHANGES WHEN THE CONTRACT FIXES THE AMOUNT?

Section 74 deals with a somewhat different situation. Instead of leaving the amount of damages entirely open, the parties have themselves provided in the contract that a particular amount will

⁹ Id. § 73.

¹⁰ *Murlidhar Chiranjilal v. Harishchandra Dwarkadas*, AIR 1962 SC 366, 369–70 (India).

¹¹ *Kailash Nath Assocs. v. Delhi Dev. Auth.*, (2015) 4 SCC 136, 150–51 (India)

become payable upon breach. This is commonly described as a liquidated damages clause.¹² But Section 74 contains an important safeguard. It does not say that the entire amount mentioned in the contract automatically becomes payable. It permits reasonable compensation not exceeding the amount stipulated.

The distinction is critical. The contractual amount is therefore a ceiling. It is not necessarily the amount that must be awarded. This principle has travelled through several important judgments of the Supreme Court.

1. Fateh Chand: The Foundation

The modern Indian law on Section 74 substantially begins with the Constitution Bench judgment in *Fateh Chand v. Balkishan Das*, 1963. The Supreme Court rejected a rigid distinction based merely upon whether a contractual clause was described as liquidated damages or a penalty. The controlling consideration under Section 74 was reasonable compensation.

The Court explained that Section 74 dispenses, in appropriate cases, with proof of the precise amount of actual loss. But that does not mean that compensation becomes punishment.¹³ This is perhaps the first principle that an arbitral tribunal must keep in mind: Section 74 relaxes the requirement of proving the exact quantum of loss; it does not abolish the compensatory character of damages. The question therefore is not simply: “What amount does the contract mention?” The better question is: “What amount constitutes reasonable compensation for the consequences of this breach, subject to the contractual ceiling?”

2. Maula Bux: When Loss Can Be Proved, Evidence Matters

The Supreme Court carried this reasoning forward in *Maula Bux v. Union of India*, 1969. A useful distinction emerged. There may be contracts where the loss resulting from breach is extremely difficult, or practically impossible, to calculate with mathematical precision. In such cases, a genuine pre-estimate made by the parties assumes considerable importance.

But there are other cases where the loss is capable of being calculated. If actual loss can reasonably be proved, the party claiming compensation cannot simply avoid the evidentiary

¹² *ONGC Ltd. v. Saw Pipes Ltd.*, (2003) 5 SCC 705, 716–18 (India).

¹³ *Id.*; see also *Maula Bux v. Union of India*, (1969) 2 SCC 554, 557–58 (India).

exercise and demand the contractual amount as an automatic entitlement.¹⁴ This distinction remains extremely relevant in arbitration.

A tribunal should therefore ask at an early stage: Was this a kind of loss that could reasonably have been quantified? If the answer is yes, the absence of evidence assumes significance. If the answer is no, a genuine and reasonable pre-estimate agreed by commercial parties assumes greater importance.

3. ONGC v. Saw Pipes: Commercial Certainty and Genuine Pre-estimate

The law received an important development in *ONGC Ltd. v. Saw Pipes Ltd.*, 2003. The Supreme Court recognised that in certain commercial contracts it may be difficult or impossible to prove the exact financial consequence of delay or breach. Where sophisticated parties have agreed in advance upon a genuine pre-estimate of the likely loss, and the amount is neither unreasonable nor penal, the claimant need not necessarily prove the precise loss through mathematical evidence.

This principle serves an important commercial purpose. Parties include liquidated damages provisions precisely because they may wish to avoid a future dispute over the exact calculation of loss. A genuine pre-estimate provides commercial certainty.¹⁵ But *Saw Pipes* should not be understood as saying that every amount described as “liquidated damages” must be awarded.

The qualification is equally important: the amount must represent a genuine pre-estimate of the probable loss and not a penalty. The Supreme Court emphasised reasonable compensation, and the contractual stipulation operates within that framework. Thus, party autonomy is respected, but it does not override the statutory requirement of reasonableness.

4. Kailash Nath: No Loss, No Windfall

The law was further clarified in *Kailash Nath Associates v. Delhi Development Authority*, 2015. The judgment brought the compensatory foundation of Sections 73 and 74 back into sharp focus. The Court explained that compensation is fundamentally connected with loss or damage. Where loss is capable of proof, such proof cannot ordinarily be avoided merely by relying upon the words “whether or not actual damage or loss is proved” in Section 74.¹⁶

¹⁴ Hasit Seth, *Liquidated Damages Law in Indian Construction Industry: A Critical Analysis*, Proceedings of the 2023 Conference of Indian Institute of Technical Arbitrators 1–8 (2023).

¹⁵ M. P. Ram Mohan et al., *Liquidated Damages in India: Concepts, Enforceability, and Drafting Considerations*, IIMA Working Paper No. WP-2024-12-02, at 3–5 (2024).

¹⁶ Amit Meharia & Sambhav Choudhary, *Disentangling Section 74 from the Illusion of Actual Loss: The Pitfalls of Headnote-Based Misinterpretation*, Bar & Bench (July 23, 2025).

At the same time, where it is difficult or impossible to prove the precise amount of loss, a genuine pre-estimate may be awarded as reasonable compensation. The important distinction is between the existence of loss and the precise proof of its quantum.¹⁷

Section 74 may dispense with strict proof of the precise amount in an appropriate case. It should not ordinarily become a mechanism for granting a windfall where no compensable injury exists at all. The Court therefore reiterated that the amount stipulated in the contract represents the maximum compensation that may be awarded; reasonable compensation may be lower.

This is an important restraint on arbitral discretion. A tribunal cannot reason that because ₹10 crore is mentioned in the contract, ₹10 crore necessarily follows from proof of breach. There remains an intervening judicial exercise: What is reasonable compensation?

5. Construction & Design Services: The Difficulty of Proving Public Loss

The decision in *Construction & Design Services v. DDA*, 2015.¹⁸ The contract concerned construction of a sewerage pumping station. The Court recognised that delay in completing infrastructure serving a public purpose may cause consequences that cannot easily be translated into an accounting entry.¹⁹

How does one precisely calculate the financial loss caused by delayed public infrastructure? The absence of a neat balance-sheet entry does not necessarily mean that no loss occurred. Accordingly, where the nature of the project itself demonstrates that delay would cause loss and the parties had reasonably estimated that consequence beforehand, insistence upon exact proof may defeat the commercial purpose of a liquidated damages clause. This principle has now assumed renewed importance.

6. The 2026 Position: Saisudhir Energy v. NTPC Vidyut Vyapar Nigam

The Supreme Court revisited the issue in January 2026 in *M/s Saisudhir Energy Ltd. v. M/s NTPC Vidyut Vyapar Nigam Ltd.*, 2026.²⁰ The dispute arose from delay in commissioning a solar power project under the Jawaharlal Nehru National Solar Mission. The Power Purchase Agreement contained a detailed liquidated damages mechanism. The dispute went to arbitration and ultimately reached the Supreme Court.

¹⁷ Pallavi Singh Rao, Sukanya Singh & Tridib Mandal, *Section 74 and the Proof Paradox: The Evolving Judicial Standard for Enforcing Liquidated Damage Clauses in Indian Contracts*, SCC Times (July 27, 2026).

¹⁸ *Construction & Design Servs. v. Delhi Dev. Auth.*, (2015) 14 SCC 263, 270–72 (India).

¹⁹ Angad Varma, Toyesh Tewari & Agastya Sen, *Damages Without Proof of Loss: The Supreme Court's Overbroad "Public Utility" Presumption*, Bar & Bench (Mar. 23, 2026).

²⁰ *Saisudhir Energy Ltd. v. NTPC Vidyut Vyapar Nigam Ltd.*, 2026 INSC 103, ¶¶ 1–4 (India).

The Court treated the public character of the project as significant. It held that a project intended to advance solar energy and environmental objectives involved public interest. In such circumstances, the loss caused by delay could not necessarily be measured merely by asking whether the government entity had shown a particular financial debit in its books.

Most importantly, the Court observed that in a public utility project of this nature, the burden may fall upon the party in breach to demonstrate that the delay caused no loss or that the stipulated liquidated damages were penal. This represents an important practical development.

It does not eliminate the requirement of reasonable compensation. Rather, it recognises that the manner in which loss is established depends upon the nature of the contract itself. The law cannot demand mathematical proof of something which, by its very nature, is incapable of exact mathematical proof.

LIQUIDATED DAMAGES CANNOT BECOME A PENALTY

The thread running through these judgments is remarkably consistent. Contract law compensates. It does not punish. A clause becomes problematic when the amount stipulated bears no reasonable relationship to the anticipated consequence of breach and operates substantially as a threat designed to compel performance. For example, a contract worth ₹1 crore provides that a delay of one day will result in damages of ₹50 lakh, irrespective of the nature or consequence of the delay. Merely describing this amount as “agreed liquidated damages” cannot make it reasonable. The tribunal must examine substance rather than nomenclature.

Conversely, suppose a large infrastructure contract contains a carefully calculated daily rate for delay, based upon financing costs, project overheads, expected revenue loss and other consequences which were difficult to calculate precisely in advance. Such a clause stands on a very different footing. The question is therefore not whether the contract uses the expression “liquidated damages”. The question is what the clause actually seeks to achieve.²¹ If its object and effect are compensatory, Section 74 may support it. If its real character is punitive, the contractual figure cannot simply be enforced as written.

²¹ Saanvi Santosh KP, “Liquidated Damages and Penalty Clauses: Judicial Interpretation in India” (2026)

THE TRIBUNAL'S REAL INQUIRY

For arbitral tribunals, the better approach is not to treat Sections 73 and 74 as two isolated compartments. They form part of one compensatory scheme. Section 73 provides the basic principle: compensate loss caused by breach, subject to causation, foreseeability, remoteness and mitigation. Section 74 addresses the special situation where the parties have already attempted to estimate the consequence of breach. It gives significance to that agreement but subjects it to the controlling requirement of reasonable compensation.

This suggests a practical sequence of questions for an arbitral tribunal: First, was there a breach attributable to the respondent? Second, did the breach cause a legally recognisable injury or loss? Third, is the loss capable of reasonable proof? Fourth, if actual damages are claimed, has the claimant established the causal connection between the breach and each head of loss? Fifth, if liquidated damages are claimed, does the contractual amount represent a genuine and reasonable pre-estimate of the probable consequences of breach? Sixth, is the stipulated amount compensatory or does it operate substantially as a penalty? Seventh, even if the clause is valid, what amount constitutes reasonable compensation in the circumstances?

These questions prevent two opposite errors. The first is awarding the entire contractual amount mechanically merely because a breach occurred. The second is rejecting a legitimate liquidated damages claim merely because the claimant cannot produce mathematical evidence of a loss which was inherently difficult to quantify.

ARBITRATION MAKES THE DISTINCTION EVEN MORE IMPORTANT

The distinction assumes additional significance in arbitration because an award is expected to disclose a rational basis for the damages granted. An arbitral tribunal undoubtedly enjoys considerable latitude in appreciating evidence and interpreting commercial contracts. But a damages award should still demonstrate the bridge between breach, injury and compensation. A large figure cannot be transformed into damages simply by describing it as reasonable. Likewise, a liquidated damages clause cannot be transformed into a penalty merely because exact proof of loss is unavailable.

The tribunal must examine the contract, the commercial setting in which the clause was negotiated, the nature of the breach, whether loss was foreseeable, whether its exact quantification was possible, the material produced by the parties and the proportionality

between the stipulated amount and the consequence sought to be compensated. That exercise is particularly important because an award granting damages contrary to the substantive principles governing compensation may subsequently face scrutiny under the Arbitration and Conciliation Act, 1996.

FROM FATEH CHAND TO SAISUDHIR: WHAT HAS REALLY CHANGED?

At first sight, the decisions from *Fateh Chand* to *Saisudhir Energy* may appear to pull in different directions. They do not necessarily do so. The common principle is that reasonable compensation is the controlling standard. What has evolved is the Court's understanding of proof. Where the loss is capable of calculation, evidence of that loss ordinarily matters. Where the exact loss is inherently difficult to quantify, the law gives greater weight to a genuine pre-estimate agreed by the parties.

Where public infrastructure or public utility is involved, the courts have recognised that the injury caused by delay may extend beyond an immediately measurable financial loss. But none of these situations converts Section 74 into a provision for punishment. The contractual figure remains a ceiling, not an automatic entitlement. The character of the clause remains open to scrutiny. And compensation must remain reasonable.

CONCLUSION: THE DIFFERENCE BETWEEN A DEBT AND A MEASURE OF COMPENSATION

Perhaps the most useful way of understanding liquidated damages is this: the figure written in the contract is not necessarily a debt that becomes automatically payable upon breach; it is ordinarily the parties' agreed measure or ceiling for compensation, subject to Section 74. That distinction matters greatly in arbitration. A claimant cannot say: "There is a breach, therefore give me the amount written in the contract." Nor can the respondent always say: "You have not proved every rupee of actual loss, therefore nothing can be awarded."

The correct answer lies between these extremes. The tribunal must determine whether loss or legal injury resulted from the breach, whether that loss was capable of precise proof, whether the contractual estimate was genuine and reasonable, and whether the amount claimed remains compensatory rather than penal.

The evolution from *Fateh Chand* and *Maula Bux*, through *Saw Pipes* and *Kailash Nath*, to *Construction & Design Services* and now *Saisudhir Energy*, shows that Indian law has gradually developed a commercially sensitive approach without abandoning its central principle. A contract may estimate damages. It cannot authorise punishment. And that, ultimately, is the dividing line between compensation and penalty under Sections 73 and 74 of the Indian Contract Act.

