Economics Analysis of Breach Remedies under Indian Contract Law[#]

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Abstract

The paper analyses the efficiency implications of breach remedies provided under Indian Contract Act and Specific Relief Act in the light of existing literature. The Indian contract law is based on English law, and both share many rules regarding the award of the breach remedies. The paper argues that Indian contract law needs to be more flexible in awarding specific performance and providing parties agreed damages when the parties involved are sophisticated enough to take informed decision. Though, Indian law is based on English law, they differ significantly on some points. The paper discusses the efficiency implication of two provisions in which Indian contract law differs significantly from English contract law.

1. Introduction

A contract is a promise exchanged among parties to do something in the future; hence there is a time lag between the exchange of promises and the performance. A mutually agreed contract creates wealth or brings pareto-improvement, since a party will enter into a contract only if he expects to gain more than the cost of performing his part of promise. However, there is always an uncertainty regarding the future, and a party (any time between making contract and his performance) may find that his net gains from

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performance, opposite to his expectations, are less than its cost. Also, the party may receive a better offer for the same performance. So, the party may find breach more beneficial than the performance of the promise. Further, when there is a time lag between the performances of two parties, a party who has already received the performance from other party can gain by not performing as per his promise.

The relationship-specific investment presents another issue in contract enforcement. When a party has made asset-specific investment based on a contract with the other party in period 1, the bargaining power of second party increases in period 2. Renegotiation of contract terms in period 2 leaves lesser share of surplus (generated by the exchange between to parties) to first party than what he would have got if the exchange had happened as per the contract in period 1. Therefore, the relationship-specific investment requires long-term credible commitment to ensure investment, and lack of it results in underinvestment (Joskow, 1987; Williamson, 1983) As a result, when there is no way to ensure performance, there will always be an uncertainty regarding the fulfillment of the promise, and the investment which requires contract will not happen. And, a party will not enter into a contract until there is a mechanism to ensure the performance.

A party, which finds breach more beneficial than performance, will keep his promise only if there is mechanism to punish him in a way that the breach no longer remains beneficial to him. Despite the uncertainty regarding the performance, not all contracts need external enforcement. And, there are many contracts which are self-enforcing. A contract is self-enforcing when the interaction is repeated for infinite rounds and a party's payoff from cheating is less than his discounted long-run payoffs of future contracts (Telser, 1980). However, a contract to be self-enforcable has to fulfill following two conditions. First, no party should know the time of ending their relationship. In case, parties know about the number of rounds they are going to play, one party may find it beneficial to cheat in the last round, whereas knowing about the expected cheating, the other party will not perform in the last round. Since the defaulting party will also expect this, he will do cheat one round earlier, and the other party will again expect this. Extending this logic will show that the parties will expect cheating even in the first round, therefore the contract will not happen even for the first round. Second, the party should

not discount the future payoffs at very high rate, because a high discount rate may make the aggregate present value of the expected gains from the repeated future contracts less than the gains from cheating.

In addition, a party may also not breach, if the breach can lead to loss of his reputation in the market which, in turn, results into the financial loss because he will lose trust of other potential contracting parties (see, Klein and Leffler, 1981), hence would not be able to make profits by having contracts with them. However, for reputation to be effective in contract enforcement, the potential future contracting parties should know about reasons for the breach, which is often difficult in large economies.[1]As a result, the role of third party, particularly law, as contract enforcer becomes important when the contract is not self-enforcing and loss of reputation may not pose credible threat to stop breach.

Law by enforcing the contract can remove the uncertainty regarding the gains from the contract. An efficient law requires courts to enforce the terms of the contract in the original form. It is because, parties will agree to a term only if it benefits each one of them, which signifies pareto-improvement. In other words, a contract provision is efficient only if it has been agreed upon by all parties. Thus, courts by enforcing the contractual terms ensure efficiency, which requires writing a complete contract that provides a solution for all possible contingencies. However, bargaining over a remote situation may increase the cost of contract more than the expected loss due to that contingency (Cooter and Ulen, 2004). Therefore, it will be efficient to leave gaps in the contracts in certain cases. Moreover, parties may not posses the information required to bargain on each possibility. Shavell (1980) argues that damage remedy provides the substitute for the complete contract. Law prevents breach by requiring the defaulting party to pay damages to the innocent party. However, compelling the party to perform, when the breach results into greater total wealth of all parties, is not efficient. A breach is efficient when a party will be better off by defaulting even after paying the innocent party the profits, he was expecting from the contract, that is, no one is worse off and at least one is better off. Hence, an efficient law prevents all inefficient breaches and allows the

[1] Reputation may play a role in contract enforcement in case of trade association, where trade union records can provide the credible information about the history of a firm (see, Bernstein, 2001).

efficient breach. Though, law, by requiring the defaulting party to compensate for loss of plaintiff's profit, can discourage inefficient breach, the calculation of damage in itself pose a problem. In addition, the amount provided by the parties as damage and other provisions, which have indirectly impact on the amount of damage or post-breach bargaining, also have efficiency implications.

There are a number of studies which have analyzed the contract law in the economic framework in the context of common and civil law countries (see, for example, Posner, 2003 and Hatzis, 2003). There are also some studies in law and economics framework in Indian context. These studies are mainly in the area of property rights (Sarkar, 2007; Morris and Pandey, 2007), tort (Babu, 2010; Jain, 2010), financial regulations (Somashekar, 2010) and weak enforcement of the law (Santhakumar, 2003). However, the issues related to Indian contract law have been remained unexplored. In this context, this paper is an attempt to understand Indian contract law in the light of existing literature. Since the efficient enforcement of the contract largely depends on the remedies provided for the breach under different situations, it is important to examine the legal remedies available under the contract law. Therefore, the focus of the present paper will be limited to the economic analysis of the breach remedies provided by Indian courts.

The Indian legal system is based on English Common Law tradition, and has similarities with other common law countries. Indian Contract Act (ICA) was first instituted in 1872 and amended from time to time.[2] Though, ICA is not applicable to situations or places where any Statute, Act or Regulation exist to deal with the issue, it is applicable to large number of cases and lays down the general principles of the legal solutions for the contract breach. Section 73 and 74 of ICA provide the rules for award of damages, where the former discusses the provisions regarding the measurement of damage by court and the latter deals with the rules applied in case the damages are liquidated. Further, the Specific Relief Act 1963 (SRA) discusses the situations under which the remedy of specific performance is available for breach of contract. Though, Indian contact law is

[2] The discussion on Indian contract, in this paper, is based on Pullock and Mulla, 2006a and 2006b unless mentioned otherwise.

similar to English contract law on most of the aspects, it shows significant difference on a few rules as well as their explanations.

The arguments by many law and economics scholars who consider contract rules in common law countries efficient by and large favor ICA too. However, all scholars does not consider contract law of common law countries efficient, and they significantly differ in their views on many issues. One issue, which is highly debated in literature, is relative efficiency of damage remedy and specific performance (see, Ulen, 1984). Another debated issue is the rules regarding penalties, where the common and civil law countries differ significantly (see, Hatzis, 2003). As already mentioned, ICA does not follow all rules of English contract law, and also differ from American Uniform Commercial Code. Two rules, where the Indian law departs from English law, are allowing exclusion of right to claim damages by express contract, and not allowing court calculated damages when sum, which is to be provided in case of breach, is named in the contract. The studies have argued in favor of the first provision especially when the contracting parties are sophisticated enough to take a rational decision (see, Schwartz and Scott, 2003). The second departure may also be efficient, when loss of plaintiff, which is often difficult to assess, is less than the damages calculated by the available methods. For example, the damages calculated by difference between the contract and the market price at the time of breach may be higher than the loss of plaintiff' profit, which is often unobservable.

The paper is divided into five sections. Following the introduction, section 2 discusses the remedies provided by the court for the breach of contract, which includes general principle of damage measurement, rules regarding liquidated damages and specific performance. Section 3 analyzes the rights of the contracting party to exclude the contract damages by an explicit provision in the contract. The rules regarding the burden of proof are examined in the next section. And the last section concludes the study.

2. Breach Remedies in India

Indian courts provide relief to the innocent party for contract breach under ICA and SRA. ICA, under section 73 and 74, covers the general principles of contract damage and liquidated damages, respectively. SRA deals with the remedy of specific performance.

These acts establish the basis of damage measurement and have implications for the decision of the parties to enter into a contract. Because, a remedy, which does not secure the rights of any of the party or gives one party a chance to profit at the cost of the other, has an adverse impact on economic activity. The present section discusses the remedies provided under the two acts and analyzes them taking into account the insights from law and economics literature. The section, at first, analyzes the general principles of awarding damages, which is followed by the discussion on the issue of liquidated damages and penalties. At last, the importance of specific performance in relation to the damage remedies is examined.

2.1. General Principles of Contract Damages

When the contract is broken, the readily available remedy in India under the contract act is the award of money damages. The contract act in India (like other common law countries) is based on the principle that the promisor has the choice to either perform as per the contract or default and pay for the plaintiff's loss. In this regard, section 73 of ICA discusses the provisions to award the damages to the plaintiff. In case a contact has been broken, the section 73 entitles the party who has suffered the breach to receive compensation from the defaulting party for any loss or damage which arise in the usual course of the things from such breach (that is, the defendant can expect that to happen in the event of breach from the nature of contract even when plaintiff has not explicitly told about it) or the parties knew while making contract that it is likely to occur from breach. Any remote or indirect loss resulted from the breach is not compensable under the contract act. Thus, the basis of calculation of damage is the loss of the plaintiff and not the gain to the defendant. ICA tends to cover the losses suffered by the innocent party so that he can achieve the same welfare level as if the contract is performed. However, the plaintiff can claim only those losses, which are the direct result of breach (that is, indirect losses are not allowed) and can be reasonably foreseen. Further, the plaintiff is also required to take necessary steps to mitigate the loss due to the breach, and cannot claim damage for any loss which is the result of not taking these steps.

In principle, the courts try to compensate the innocent party for his loss due to breach. Nonetheless, the courts also use other damage measure. The courts use three types of damage measures, namely, restitution damage, reliance damage and expectation damage. The expectation damages puts the plaintiff in as good a position as he would have been if the defendant had not defaulted. The reliance damage covers the expenditure that an innocent party has done in reliance of the defaulting party. It seeks to put the plaintiff in a position as good as if the contract was never made. The restitution damage is awarded to prevent the defendant to benefit from the plaintiff's loss. This damage measure compels the party at fault to surrender his those gains from the breach, which are reflected in plaintiff's loss. Though, the primary objective of the contract is to protect expectation interest (by awarding expectation damages), the reliance damage is provided to avoid wastage when it is difficult for plaintiff to prove the benefit that he was expecting from the contract. The restitution damage normally is not preferred. The courts generally do not ask the defendant to surrender his gains from the breach, unless they are reflected in the loss of plaintiff. However, restitution measure is used in cases, such as, the defendant fails to provide the goods or service after receiving payment for it; or the defendant has made profit by doing the same thing which he agreed not to do; or the defendant wrongfully used the trade secret or other confidential information in the breach of contract for his gain.

A dominant strand in law and economics literature shows that the award of expectation damage leads to an efficient outcome (see, Posner, 2003). To illustrate, suppose *A* contracted with *B* to provide him *q* quantity of a good G at a price p_s per unit, which he is intended to use as input to produce other goods. *B* fails to deliver the good on the due date, and *A* suffers a loss as a result of it. Suppose, at the time of breach *B* has an option to purchase the good from the market at a price p_m (the case of non-market goods will be discussed latter), where $p_m > p_s$. Therefore, *B*'s loss due to *A*'s non-performance is $q*p_m - q*p_s$. Let, *g* represents the *A*'s gain from breach. In case, *A* is required to compensate *B* for his loss, he will choose not to perform only if his gain from the breach is more than the *B*'s loss, that is, $g > q*p_m - q*p_s$. On the other hand, any compensation, which compels the defaulting party to perform, results into a net loss of $g - (q*p_m - q*p_s)$. It is

because, the loss of defaulting party from performance will be g, whereas the gain of innocent party will be $q*p_m - q*p_s$. Since gains from breach are higher than the loss, there will be a net loss of $g - (q*p_m - q*p_s)$ due to performance. Hence, the aggregate welfare of both the parties will be higher from the breach than the performance when the gain of defaulting party are higher than the loss of the innocent party.

However, the economic analysis of reliance and restitution damages does not support the efficiency criterion (Ulen, 1984). To understand the implication of restitution damage, suppose *A*, in previous example, has given an amount '*a*' as an advance for the good. In this case, the restitution damage will require *B* to return the advance paid to him. Since the advance was the part of total amount that *B* was supposed to get on completion of the contract, returning the advance will not have any impact on his decision. And *B* will have an incentive to breach for any amount greater than the contract amount. Thus, the restitution damage will be inefficient, since the breach will be efficient only if *B* is ready to pay a sum larger than *A*'s loss (which is required to ensure that aggregate wealth is higher because of breach), whereas the restitution does not require *B* to compensate for *A*'s loss. On similar lines, Kull (1995), criticizing the present propositions of restitution, argues that restitution should not be considered as remedy for breach, since it creates a liability independent from the breach. Nonetheless, it may be efficient to award restitution damage in cases like mistaken transfer of wealth (Mather, 1982).

Similarly, reliance damage is also not based on the loss of the plaintiff, hence may lead to inefficiency. Taking the earlier example, suppose that *A* in reliance of the performance of the contract has spent an amount '*t*' for the transportation arrangement of the good. This amount cannot be recovered even if the transportation facility is not used, which results into *A*'s loss due to *B*'s breach. Under reliance damages, *A* is required to cover *B*'s loss. However, the expenditure '*t*', which *A* has done in reliance of the contract, has nothing to do with his expected gain from the contract. While, the reliance damage which are less than *A*'s gain (that is, $t < q*p_m - q*p_s$) may lead to inefficient breach, the reliance damage may prevent an efficient breach, when the plaintiff has spend more than his loss from the breach (that is, $t > g - q*p_m - q*p_s$). Also, Rogerson (1984) shows that the reliance

decision under expectation damages pareto-dominates the reliance damages. The study analyzes the reliance decisions under different contract remedies in a situation where the buyer or the seller must spend on specific capital before the exchange and post-breach bargaining is possible.

The most common way to assess the damages (whenever the market price is available for the contracted good) is the difference between the contract price and the market price of the good. This method provides the expectation damage to the plaintiff, which is the most efficient and also the most preferred damage measure among the three. For example, if p_s is the contract price of the good and p_m is the market price of the good on the date of delivery, the damages are generally assessed by taking the difference of the two prices, that is, the extra amount which a buyer has to pay to purchase the same quantity of the good from the market, or the amount lost by the seller due to breach by buyer. However, in case of delivery of defective goods, which were accepted, the difference between contract price and market price of the good is not used to calculate damages. In this case, the damages are assessed using the difference between the actual price of the good and the price that the good would have had if the good was of right quality. The reason for this is that it is easy for the party who has the good to sell it or put into other use (Posner, 2003). That is why, the seller is responsible to put the good in its best use if he occupies the good, and the responsibility of putting the good into right use lies on buyer once the good is delivered to him. The market place of the good is generally measured at place of breach. When, the market for the good is not available at the place of breach, the price in the nearby market is used to assess the damage. If the good is not marketable, such as, goods made on order, the price of the good is the measure of damage. In case, the good cannot be purchased from the market, the price at which good is sold to the third party is used as the measure of damage. The reason for this rule is that the value of the non-market good for the plaintiff cannot be calculated. Therefore it is efficient to compel the defendant to perform (the case of the non-market good is discussed in detail under section 'specific performance'). The court, by asking the defendant to pay the difference between the contract price and the price at which the good was sold to third party when the good is non-market, compels him to surrender his benefit from the breach, thereby ensuring the performance since defendant will not have any incentive to breach.

Another important issue is that the contract law requires plaintiff to take necessary steps to mitigate the losses, that is, he is expected to minimize his losses due to breach. This rule prevents unjust enrichment of the plaintiff at the cost of defaulting party, and ensures efficiency. Taking the previous example, the innocent party can purchase the same goods from the market at price p_m. If he purchase the goods from market and perform, his loses from breach will be $p_m - p_s$. However, in case plaintiff fails to take necessary steps to minimize the loss and his loss will be higher than $p_m - p_s$. Compensating plaintiff for such loss, which occurred as a results of his failure to take necessary steps, will lead to higher losses from the breach. On the other hand, if the loss due to failure to mitigate is deducted while calculating the damages, the innocent party will have an incentive to act in a way that will minimize the loss and maximize the aggregate benefits. Further, putting the responsibility to mitigate on plaintiff will be efficient, because he is in a better position to understand his needs and search for an alternative sources at lesser cost. In fact, if promisor is in a better position to find the alternative at lesser cost than promisee, then it would be in his own best interest to purchase the good from the market and supply it to the promisee (see, Posner, 2003).[3]

Furthermore, under the ICA only those damages for the loss are allowed, which may reasonable be considered arising in the usual course of the things from such breach, or have been in the contemplation of the parties while making contract as the likely result of the breach. ICA does not provide damages for any event, which is remote. The logic behind this provision is that not compensating for any loss, which was not known to the parties, could not have influenced the decision of the parties about entering into a contract. It is because, the parties will not include any remote damage into their calculation while taking decision about the contract formation and default. Therefore, providing such damages will not result into increase in efficiency. On the contrary, allowing compensation for remote damages will lead to inefficiency, since the contracting parties will have no incentive to reveal the information about the possible effect of breach (Posner, 2000). By allowing only those damages, which are in

[3] Some studies have expressed disagreement over this point. Schwartz (1979) argued that seller being a supplier of the good is more likely to know about the market than the buyer.

contemplation of the contracting parties at the time of making the contract, the law gives the parties an incentive to reveal information regarding the possible impact of the breach. As a result, the party while making a default will take the likely damage into consideration.

In addition, the literature also argues that not compensating for indirect loss is efficient and put the responsibility to avoid the risk on the party which has superior knowledge of the risk. The rule is based on the famous contract case *Hadley v. Baxendale.*[4] In this case, the court denied to award damage for unforeseeable consequential loss. Posner (2003) explains the economic implication of the rule with an example of a case between a commercial photographer and a company, which sells as well as develops films. The commercial photograph purchased a roll of film from the company in dispute. The price of the film also included the cost of developing it. The film was used to take the pictures of the Himalaya for a magazine, and huge expenses were incurred to complete the assignment. He later sent the film to the manufacturer for development. But it was lost in the developing room and never found. Considering the facts of the case, Posner argues that allowing the photographer to recover damage will not have much effect on the manufacturer's efficiency, since it will be difficult for him to separate out defective films from others, or know which films are important. At the same time, the photographer will not have any incentive to take precaution. On the other hand, not allowing the damages will give the photographer an incentive to take more precautions, like using more than one roles of the film or requesting developer to take extra care. Here, it will less costly for the photographer to take precaution than the manufacturer, hence it will be efficient not to allow the damages. However, Geis (2005) pointed out that not allowing unforeseeable indirect loss is efficient, only when the distribution of buyers is such that most of the buyers value the performance low. If many buyers place a high value to the performance, the efficiency analysis does not favor *Hadley* rule. The study does an empirical analysis of three goods and finds that *Hadley* rule is efficient in all three cases. However, the results may vary for other goods based on buyer's valuation as well as

[4] Hadley v. Baxendale, 1.9 Ex. 341, 156 Eng. Rep. 145 (1854)

seller's market power. The author emphasizes on the empirical work to find the situations under which the rule will be efficient.

2.2. Liquidated damages and Penalties

The previous section has discussed the efficiency implications of the principles that are used by Indian courts to measure the damage. However, there are situations when the contracting parties name the sum that has to be provided by the defaulting party in case of breach, that is, damages are liquidated. English law differentiates liquidated damages, which are the pre-estimates of the loss, from penalties, which put much higher burden on the defaulting party than the loss of the innocent party, and the damages are not provided above what the court considers the reasonable pre-estimate of the plaintiff's loss. Nonetheless, English law allows promisee to disagree with the penal clause, and sue for the damages at large. In India, section 74 of ICA provides rules regarding the liquidated damages and penalties. ICA also does not allow the damages which are of the nature of penalty. However, ICA does not give the promisee a freedom to choose between the penalty clause (that is, claim under section 74) and court measured damages. ICA provides general principle for the contracts in which a sum is named in the contract as the damage to be paid in case of breach. Under the penalty clause, the party complaining of the breach is entitled to receive from the defaulting party a reasonable compensation not exceeding the amount mentioned in the contract or stipulated as penalty, that is, the sum named is treated as ceiling in Indian contract law. The present section, at first, discusses the issue of penalty, and then the impact of the departure of Indian law from English law on efficiency is examined.

The issue of penalty is highly debated in the law and economics literature on contract (see, Hatzis, 2003). Common law judges are generally reluctant to award liquidated damages when they stipulate sum named in the contract is higher than the reasonable pre-estimate of the loss of promisee. On the contrary, courts in civil law countries are quite

liberal in enforcing liquidated damages even when they are in the way of penalties unless the amount mentioned is extravagant or purely gambling. The law and economics scholars who favor common law approach consider penalties inefficient since they do not permit efficient breach (as discussed in earlier, the efficiency requires the damages to be equal to the loss of innocent party) and there are chances of exploitation of promisor when there are significant difference in the bargaining power of both the parties and there is information asymmetry. In addition, if promisee is to receive higher sum in case of breach than by the fulfillment of the promise, allowing penalty clause may give the promisee an incentive to create the situation leading to the default.

On the other hand, opponents of the penalty clause argue that the awarding penalties will compensate for the idiosyncratic value of the promisee and help risk-averse to better manage the risk. It also helps to avoid the uncertainty regarding contract and reduce transaction cost of litigation. Some times promisee may also like promisor to act as insurer, and premium of the insurance is reflected in the higher price for the fulfillment of the promise (Mattei, 1995). In these cases, not awarding agreed sum will be inefficient because it will prevent the parties to enter into a contract. The penalty clause also works as a guarantee for new firms which do not have strong reputation in the market, and other firms are reluctant to do business with them. The opponents of the penalty clause, without completely rejecting the arguments in favor of penalty clause, point out that the contracting parties are best judge of their interests and the exploitation of one party by using the penalty does not happen in commercial transactions among sophisticated parties (see Schwartz and Scott, 2003). Goetz and Scott (1977) argue that initially the restriction on penalties came as a rule to prevent fraud and duress. The rule was further supported by the fact that a rational assessment of nature and extent of risk by parties was often prevented by information barriers. However, the rule was applied to all the contract cases due to high cost of finding fraud or information barriers in individual cases. Therefore, the restriction should only be applied on unfair bargaining. The restrictions on penalties will be efficient in standard form consumer contracts where the bargaining power of the consumer is much less than the corporate firm, but inefficient when applied on sophisticated players (Hatzis, 2003). Further, when there is a risk that one party can make the performance difficult, the contracting parties can write provision to restrain the other

party from doing such activities. Thus, the researchers, who are against the penalty clause, argue that the penalties should be restricted only when their is large difference in the bargaining power of the two parties such as standard form consumer contracts, or when the penalties are unreasonably high. Polinsky and Shavell (1998), however, argue that penalties should be allowed only when the defendant has significant chance of escaping the liability for the damage he has caused. They also points out that award of the punitive damage against corporations may not serve the purpose because any penalty on corporations often does not affect the employees responsible for the breach, instead it will have effect on shareholders and consumers.

The law and economics literature seems to agree on the point that the penalties should not be allowed in contracts where parties have unequal bargaining power, such as standard form consumer contracts. The dominant strand in law and economics literature is also of the view that party provided remedy is efficient if the parties are sophisticated enough to take informed decisions, and any of the party does not enjoy the dominant position in bargaining. Nonetheless, limiting the penalty clause to some of the issues, such as, standard form consumer contracts, than keeping it as a general rule, is highly debatable, and remained more or less inconclusive. De Geest and Wuyts (2000) are of the view that a dominant strand of the literature favors penalty clause, whereas Hatzis (2003) argues that the widely accepted view in law and economics literature is that penalties should be allowed. One of the reasons that the debate on the penalty clause remains inconclusive is the lack of empirical studies. The rules regarding penalty clause have important implications for Indian economy, and empirical studies may provide useful insight into the issue. Though, there are many problems of allowing the penalties, the argument, that the sophisticated parties are in a better position than court to provide remedy, therefore rejecting party agreed remedy may lead to inefficiency, cannot be rejected. In this regard, Indian contract law also needs to provide more flexibility in dealing with contracts involving well-informed sophisticated parties.

The calculation of the amount above which the liquidated damages are considered as penalty is another important issue. In India, the penalty is calculated on the basis of promisor's liability in original contract, that is, the damage that an innocent party has to

bear due to the default. For example, an illustration of the section provides that if *A*, who owes money to *B*, a money lender, undertakes to repay him by delivering to him 10 manunds of grain on a certain date, and in the event of his not delivering the stipulated amount by stipulated date, he shall be liable to deliver 20 maunds (see Pullock and Mulla, 2006b: 1658). ICA considers this stipulation as penalty and the plaintiff can only recover reasonable amount as damage. Here, law, while stipulating 20 maunds of grain as penalty, has considered original deal which was 10 maunds of grains. As a result, same amount of damage depending on the original liability can be liquidated damage in one situation and penalty in the other.

Same principle is applied in case of interest rate. Though, the interest rate in India is controlled under Interest rate Act, 1978, the provisions regarding increase in interest in case of default is decided under the section 74. For example, ICA does allow change of simple interest either into compound interest or to increase rate upto a certain point in case the money is not repaid on the due date. However, both increasing the rate of interest as well as making it simple to compound cannot be done in the event of breach. For instance, assume that *B* is supposed to pay *A,* a simple interest rate of 10 percent per annum on a debt of Rs. 10,000. *A*, in case of not paying debt on time, can either demand from *B* an interest higher than 10 percent or charge compound interest at the same rate (that is, 10 percent) instead of simple interest, but cannot do both, that is, promisee cannot increase the rate of interest and change simple interest to compound. A person, who is already charging compound interest of 10 percent per annum at the same amount of debt, can demand higher rate of compound interest in case of default.

The rules regarding the interest rate is based on the assumption that the opportunity cost of money for the lender remains almost the same, and the defendant has to agree on large increase in the interest rate in case of breach due to unequal bargaining power. However, these assumptions need not be true. For a person, the cost of parting with the money may be different at different points of the time, which depends on external factors like interest rate in the economy, availability of opportunities and the use in which he is thinking to put that money. At any point of time, a person may reasonably expect much higher returns from the money at a future date. It is also unlikely that a lender, who has given the

money at a rate lesser than what is allowed under Interest rate Act, was having unequal bargaining power at the time of contract to include the penalty, especially when the after breach rate is still below the maximum allowed under Interest rate Act. Hence, there is no basis in case of interest rate not to allow increase in the interest rate which is much higher than the original rate but is still below the rate which can be considered as the result of unequal bargaining power (for example, the rate allowed under Interest rate Act, 1978 cannot be considered as the result of unequal bargaining power). Moreover, the penalty may be just an instrument to ensure the timely payment of debt, which may be crucial for the lender to avoid direct and indirect losses (for example, he may need money for his important business or personal need). In fact, the large difference in the original interest rate and interest rate after breach may be the result of a concession that the person was agreed to give on original rate in return to the promise of a penalty in case of default. Here, lower original interest rate is like an insurance premium for securing the performance.

There are also certain prohibitions under penalty clause that can be avoided merely by changing the wording of the contract. For instance, in case of default, the innocent party can charge the higher rate from the date of breach (that is, the date on which debt was payable), but not from the beginning. For example, if $*A* lent *B* money on the compound interest of 10 percent per annum, and stipulated that in case of late payment, the interest payable will be 12 percent from the date of contract, this stipulation is by the way of penalty and increased interest is allowed only from the date of breach. However, charging an interest of 12 percent from the date of contract is not by the way of penalty, if *A* mentions in the contract that the interest rate on the loan will be 12 percent per annum, nonetheless *B* has to pay only 10 percent, in case he pays the debt within specified time limit. Even though the result of both the contract is same, the former is by the way of penalty, whereas the latter is not. The rules which can be avoided by changing the wording of the contract do not serve any purpose, instead they can be misused by more informed party, hence lead to inefficiency. However, these aspects need to be studied further in detail.

Though Indian and English contract laws are similar in their treatment of penalties, they depart on the issue of right of the promisee to sue for court-measured damages. ICA does not allow the innocent party to choose to sue for the penal clause or the damages at large. In Indian contract law, the sum named in the contract acts as the upper limit to which the damages can be awarded to the plaintiff, even when the damages assessed by the court would have been higher. This provision may increase efficiency, when the court calculated damages are more the actual loss. To illustrate, take the example in earlier section, where A contracted with B to provide him q quantity of a good G at a price p_s per unit, and A agrees to pay a damage of d per unit in the case of default. The market price of the good, at the time of delivery, is p_m. The damages calculated by the court will be $q*p_m - q*p_s$, whereas the damages calculated as per the remedy provided by the parties is $q*d$. If the market price of the good, at the time of delivery, is higher than the price at which damages are calculated by the parties (that is, $q*d <\$ q*p_m - q*p_s$), then it will be beneficial for the plaintiff to sue for the court provided damages. Suppose, the sum named in the contract is profit per unit that the plaintiff was expecting to make from the completion of the contract. Since, the parties are in better position to know the expected profit, but may not have enough evidence to prove it, the actual loss of the plaintiff will be less than the difference between the market and the contract price. In this case, awarding the court calculated damages would result in inefficient outcome, since it will not allow an efficient breach.[5]

2.3 Specific Performance

In previous sections, the paper has discussed the rules regarding award of damages in the event of breach. Though, money damage is the most frequently used solution by the courts to compensate the innocent party, it is not the only measure available. An additional remedy provided by the court is specific performance under which the defendant is required to perform as per the contract. The remedy of specific performance

[5] Going with the argument of researchers who favor penalty clause, making the sum mentioned in the contract as upper ceiling may creates some inefficiencies, since it allows the promisor to default even when there may not be any net increase in surplus. A further analysis of the provision is needed to know its efficiency implications.

is under the discretion of the court and is not normally awarded in India (as well as other common law countries). The specific performance, like liquidated damages, is highly debated topic in law and economics literature. Some studies argue that the present provision of specific performance in common law countries (which are the same in India) leads to efficient outcome (Kronman, 1978), whereas others show that it will be efficient if specific performance is readily enforced (Ulen, 1984). In India, the Specific Relief Act, 1963 (SRA) provide an alternative to the remedy of damages in contract act by the way of specific performance. Under this provision, plaintiff can file a suit to compel the breaching party to perform as per the contract. The Specific Relief Act 1963 is the improved version of Specific Relief Act of 1877 which was originally drafted on the lines of the Draft New York Civil Code 1862. The main provisions of the act were based on the doctrines developed by the equity court of England. Since, the Specific Relief Act 1963 is based on English law, the substantive law and practices related to different section can be interpreted in the light of decisions by English courts, unless the provision in any section explicitly conflict the principle provided by English court.

The remedy of specific performance in not generally available to the innocent party, and the relief is in the discretion of the court. This also means that the contracting parties cannot agree on the specific enforceability of the contract. The specific performance is available only in those cases when it is difficult to calculate actual damage suffered by the innocent party, or the money damage cannot compensate the plaintiff adequately. Hence, the plaintiff, for the enforceability of specific relief, has to prove that the money damages are not adequate in that particular case. Law presumes that damage is not an adequate relief in case of an agreement to purchase land, or an article which has high subjective value for the plaintiff, or article which is not an ordinary of commerce item or is not easily available in the market. The court generally does not allow specific enforcement in contracts, which need continuous supervision, such as, contract to build, repair or provide personal services. However, the courts may enforce contract requiring supervision, if the contract clearly specifies (expressly or by implication) the work to be done, so that court can enforce the contract in a way that the defendant know what precisely he has to do to comply with the court order. The rule is provided because it is difficult for the court to verify defendant's compliance with the contract, in case the

performance of the contract cannot be ascertained without incurring huge supervision cost. Further, the contract can also be specifically enforced, when the liquidated damages are provided in the contract and the party at fault is willing to pay the sum. The court in this case determine whether the intention of the parties to provide liquidated sum is an alternative contract in case of default or to secure the performance as per the contract. If courts finds that liquidated damages were to secure performance, the specific performance can be awarded.

Specific performance also ensures the efficient breach by allowing post-breach negotiation. Suppose, A contracts B to provide him a service at a price w. A expects to gain a profit m from the service, where v is the cost of B to perform the task, and he earns an amount w-v by providing the service. Now, B's cost of providing service has increased to z. Therefore, B will lose z-v by providing the service compared to his earlier situation. In this situation, the efficiency considerations require him to complete the project if $z-v<m$, and pay damage to A in case $z-v>m$. Awarding specific performance gives the same results. Here, A will be better off if he gets any amount more than m. On the other hand, B will better off by paying any amount less than z-v to purchase the right of specific performance from A. If B's loss is more than A's expected profit from the service (that is, $z-v>m)$, B will renegotiate with A and buy A's right to claim specific performance. As a result, the service will not be provided, and the damage, which will be something between m and z-v, will be paid to A. However, the post breach negotiation will not happen if A's expected gain from the project are higher than B's loss from completing the project (that is, $z-v>m)$, because B will find it less costly to complete the project than to pay A his expected profits. These results are the same as required by the efficient breach theory, that is, breach will happen only when promisor's gain from breach is higher than promisee's loss. Another important aspect of awarding the specific performance is that it protects the subjective valuation of the promisee. For example, in case, A, in addition to the profits m, attaches a subjective value, k, to the service, the breach will happen only if $z-v>m+k$. Therefore, awarding specific performance will ensure the efficient breach. However, making specific performance a routine remedy is a debated issue. The main focus of the debate is cost of pre- and post-breach negotiation. Where, one strand of literature argues that pre- and post-breach negotiation cost is lower under the present

provisions, the other strand of literature advocates making the specific performance as a routine remedy.

Kronman (1978) favors the above provisions of specific performance. He argues that these provisions are in line with what the contracting parties would have wanted as the remedy, therefore has lower pre-breach negotiation cost. The rules in this case are based on the difference between unique and fungible goods. While fungible goods can be easily purchased from the market, the unique goods have either very limited market or no market. Due to limited market in case of unique good, it is highly unlikely that seller will get a better offer. As a result, he would like the contract to be specifically enforced. The buyer would also like to have the contract specifically enforced since the damages in case of unique good will be under-compensatory due to his high subjective value. On the other hand, both seller and buyer would prefer money damage when the contract is for fungible good. It is because, the seller will expect better offer due to developed market, whereas the buyer will have less risk of under-compensation due to low subjective value. Therefore, the present provisions regarding specific performance will reduce the pre-negotiation cost of the parties.

Posner (2003) also favors the specific performance only in those cases where the good is not available in the market and it is difficult to ascertain the value of the good for the promisee. He argues that providing specific performance in fungible goods will lead to high cost of post-breach negotiation, where the promisee will try to get a share of promisor's surplus. For example, *A* contracts *B* to supply 100 quintals of rice for Rs. 10,000. Before, the fulfillment of the contract *C* offers A Rs. 12,500 for the same quantity of rice. Suppose, the market value for the contracted quantity of the rice increases to Rs. 11,000. In case of money damages, *A* will pay *B* Rs. 1,000 and sell the rice to *C* and gain a surplus of Rs. 1,500. However, when the remedy is specific performance, *B* has to negotiate with *A* to get a share of surplus. Posner argues that post-breach negotiation cost will be less in case of money damage, because the cost of determining the difference between contract and market is easier than the negotiating for the division of surplus.

Schwartz (1979), contradicting the above arguments, supports the specific performance as the routine remedy for the contract breach. The study points out that the argument that the present provisions regarding specific performance leads to lower pre- and post-breach negotiation cost is not valid. The claim that contracting parties would prefer specific performance in case of unique goods and money damage when contract is for fungible goods does not hold, because the unique goods do not lack developed market, and the seller can reasonably expect better offer. On the contrary, seller may like to have specific performance in the case of fungible goods when the competition is very high, so that he could secure the performance. Further, the view that the post-breach cost of negotiation will be higher in case of specific performance depends on the assertion that the buyer, in case of default, has lower cover-cost then the seller. However, it need not be so. It is argued that the seller already knows the exact specification of the good and often has superior knowledge of the market for the good than buyer, since each producer has to be fully aware of the market for his product and his competitors. Also, the argument that buyer, by posing a threat of legal suit, may compel the seller to perform even when his own cover cost is less is valid only if the difference between the cover cost of buyer and seller is larger than the cost of preparing legal suit to pose a threat.

Another argument in favor of damage remedy is that specific performance in case of high inflation may lead to dead weight loss if promisee stress on performance even when the breach is efficient than the performance. For example, *A* contracts *B* to complete a construction project for Rs. 10,000 (this example is taken from Schwartz, 1979). *A* expects to earn a profit of Rs. 3,000 from the project. The cost of production for *B* is Rs. 8000, and he earns Rs. 2,000. Suppose, the cost of production increase from Rs. 8,000 to Rs. 15,000. In this situation, enforcing specific performance will put a burden of Rs. 7,000 on *B*, whereas *A* will gain only Rs. 3,000 from the completion of the project. The remaining Rs. 4,000 will be a dead weight loss. In this case, allowing the breach and providing expectation damage of Rs. 3,000 will increase the efficiency. Schwartz (1979), however, notes that the dead weight loss may also happen under damage remedy, as the promisor, in the example, can claim Rs. 7,000 as the difference between the cost of contract and the market price (Rs. 15,000 of production cost and Rs. 2,000 as profit).

On similar lines, Ulen (1984) argues that the specific performance is a better remedy than money damages, and strongly recommends the specific performance as routine remedy. Most importantly, specific performance is most efficient in protecting idiosyncratic values of the promisee. The cost of determining the subjective value of the promisee in the court is very high, as a result the damage remedy leads to undercompensation. The specific performance, on the other hand, provide the innocent party at least the value he had contracted for, thus allows the contract breach only when it is efficient, that is, someone is better off and no one is worse off. Under specific performance, the parties determine who among them values the good the highest. Since, the contracting parties are in a better position to determine the highest-value user, the post-breach cost of moving the good to that party will be lower under this remedy. Further, if all valid contracts are specifically enforced, the parties will have more incentive to exchange reciprocal promises efficiently by better risk allocation at the time of contract formation, rather than depending on the court or post-breach negotiations under the threat of legal action. Ulen accepts that the cost of contracting for the sale of fungible good will increase under the specific performance. Nonetheless, he points out that Kronman's logic says that the cost of contracting around specific performance will be less when the contract is for a unique good, therefore the cost of contracting around specific performance will not be large when the good is not purely homogenous, that is, there is a certain amount of product differentiation. On the other hand, the cost of contracting will increase with increase in uniqueness of the good, when money damages is the routine remedy. Since, the share of contracts for purely homogenous products is likely to be small, the net increase will not be significant. The study also rejects the conclusion that the post-breach negotiation cost will be higher under specific performance. It is argued that the post-breach cost may be higher only in the beginning, and will come down in the latter period due to lesser number of court cases and lower litigation cost. Ulen also asserts that not enforcing the contract specifically, when the supervision cost is high, may not be efficient, if the promisor fears that the bad performance will hamper his reputation, which, in turn, has an impact on his future returns.

Brooks (2006) also argues that the efficiency criterion does not favor the present law which gives promisor power to choose to perform or pay damages (efficient breach

hypothesis) over its alternative that gives the same power to choose between performance or damage (efficient performance hypothesis) to promisee which is also considered better on moral grounds. Rogerson (1984) analyzes the reliance decisions under three contract remedies namely specific performance, expectation damages, and reliance damages in a situation where the buyer or the seller must spend on specific capital before the exchange and post-breach bargaining is possible. The study shows that reliance decision under specific performance pareto-dominates the other two remedies.

Further, the specific performance can be awarded even if the contract specifies the liquidated damage and the defaulting party is ready to pay that. The liquidated damages are ignored when the court, on the basis of evidences, is satisfied that the sum named in the contract was to secure the performance, and was never meant to be the remedy for breach of the contract. This provision is to compensate the innocent party for his subjective losses, because law does not allow the penalty clause in the contract and the parties cannot contract for specific performance as the breach remedy. Therefore, law allows specific performance even when the sum in named in the contract to be provided in case of breach, if courts are satisfied that it was to secure performance. This aspect of the specific performance has got little intension. It is because, the rule will not be required if law allows the parties to agree for specific performance or starts awarding penalties. Therefore, the studies mainly analyze the situations under which awarding specific performance will be efficient.

The literature shows disagreement on the likely effect of making the specific performance a regular remedy. The answer to the question mainly lies in pre- and post-breach negotiation cost under money damages and specific performance. Though, the lack of empirical evidences are main reason that the debate remains inconclusive, the view that specific performance should be made a regular remedy seems to dominate the other. Nonetheless, there is an immense need to have more studies (especially empirical) to understand the effect of present rules of money damages and specific performance.

3. Express Provisions in the Contract for Relief

The contract act, in certain cases, allows the remedies that are agreed on by the contracting parties. One of these kinds of provisions is the right of the parties to exclude the right to claim damages. ICA gives the parties a right to exclude the right to claim damages by writing a provision in plain and unambiguous language in the contract. In this case, ICA is different from English Law, which restrict a similar provision to exclude or limit the right to claim by statute. Nonetheless, ICA does not allow a party at fault to benefit under this provision. In addition, the remedy of suit for damages in case of breach is not excluded, even if contract has provided other remedies. Schwartz and Scott (2003) show that it is efficient to provide a remedy according to the terms of the contract, when the contract is of commercial nature and the parties in a contract are sophisticated enough to take decision in their best interest. The choice of exclusion of right to claim to the parties by express contract under the act provides more flexibility to the parties to contract around the terms which they think are best suited to them and maximizes aggregate wealth of the parties. Nonetheless, the contracts, where the contracting parties does not have equal bargaining power and information as in the case of consumer contracts, should be protected by different laws.

4. Burden of Proof

Besides the provisions of contract remedies, the other important issue is the burden of proof. The issue of providing proof is crucial for proving the breach, choice of breach remedy and right assessment of the damage. Before measuring and awarding damage, the law requires the plaintiff to prove the breach. Further, Plaintiff is supposed to provide the proof of loss which directly resulted from the breach, and prove that the loss is such that it was expected to arise naturally from such breach or was in the contemplation of the parties at the time of formation of the contract that it will arise from the breach. Nonetheless, the loss need not be proved with certainty, and no proof of loss is not a reason not to award damages. Further, the burden of proof to reduce the amount of damage from the maximum possible (based on the proofs provided by plaintiff) is on defendant. The studies argue that the burden of the proof should fall on the person who

can provide the evidence at lower cost, and also compel them to disclose the information (see, Posner, 1999; Hay and Spier, 1997). In the light of economic analysis of law of evidence, the provisions in ICA can be considered efficient. The plaintiff is in the better place to prove the breach and provide evidence regarding his loss due to breach than the defendant. It is because, there may be many ways that a breach can happen and the defendant has to prove that breach has not happened in any of the possible ways, whereas the plaintiff has to provide the evidence only on the kind of breach that has happened. In addition, the plaintiff is more likely to have information regarding the breach, for instance, it is easy for the plaintiff to prove that the goods delivered were defective, because he will have the possession over the good and can point out the exact defect in them. Similarly, it is easier (or less costly) to prove that the defendant party had the information regarding the likely impact of the breach on the plaintiff than proving that information was not provided. Therefore, it will be efficient to require the plaintiff to prove that loss is the direct result of the breach and was in the contemplation of the defaulting party at the time of making the contract that it will arise from such breach. However, proving the exact amount of loss is difficult in most of the contracts, hence requiring the plaintiff to prove the loss with certainty may lead to under-compensation when loss is hard to measure, which will result in inefficient outcome by giving defaulting party an incentive to go for inefficient breach. It will also be costly for plaintiff to prove that he had taken all the necessary measure to mitigate the loss, since there he has to prove that no other option was available. However, the defendant has to prove just the availability of the solution which could be used to mitigate the loss. Thus, the cost of proving that other alternative was available will be lower for defendant.

5. Conclusion

The present paper analyses the efficiency implications of damage remedies provided under ICA and SRA. In addition, the implications of the provisions, the exclusion of the right to claim damage by explicit contract and not allowing court calculated damages when sum, which is to be provided in case of breach, is named in the contract, are also discussed. The study finds that Indian contract law has many similarities with English law, and is based on the principle of compensating the innocent party for his foreseeable

loss. A large number of studies in the contest of common law countries show that Indian contract law is efficient. However, there is significant amount of literature, especially in the context of penalty clause and specific performance, which criticized the common law approach on efficiency grounds, and emphasized that the courts, to ensure efficiency, should enforce the contract terms related to penalties and also adopt more liberal approach towards the specific performance.

Despite the fact that Indian law is based on English law, they differ significantly on some points. One of the point where Indian law is different from English law is that Indian contract law does not allow promisee to sue for court calculated damages if liquidated damages are provided in the contract. It is argued in the paper that Indian law is efficient in this case, because the parties know more about their expected loss from the breach, and court's assessment of the damages (which are often calculated as the difference between the market and the contract price) may be higher than the actual loss due to lack of proof on profits. Another point of difference is the rules regarding the exclusion of the right to claim damage by explicit contract, which is allowed under Indian law. This rule goes in accordance with the argument by many scholars that parties, especially the sophisticated one, are in better position than the court to decide about the provisions. Hence, the exclusion should be allowed until there is a chance that the provisions are the result of unequal bargaining power or asymmetric information among parties.

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