P L D 1969 Supreme Court 80

Present: Hamoodur Rahman, C. J., Muhammad

Yaqub Ali, Sajjad Ahmad, Abdus Sattar and

Qadeeruddin Ahmad, JJ

PROVINCE OF WEST PAKISTAN----Appellant

versus

MESSERS MISTRI PATEL & Co. AND ANOTHBR---Respondents

Civil Appeal No. K-8 of 1964, decided on 21st January 1969.

(On appeal from the judgment and order of the High Court of West Pakistan, Karachi Bench, Karachi, dated the 26th November 1962, in Letters Patent Appeal No. 64 of 1969).

(a) Contract Act (IX of 1872), S. 74--Earnest money, forfeiture or recovery of-Covenant for forfeiture of earnest money or deposit actually made or amount recoverable on failure to perform contract-Covered by expression "if the contract contains any other stipulation by way of penalty" - Despite express stipulation in contract, Court, on equitable principles, can relieve defaulting buyer from forfeiture of earnest money if circumstances of case justify such a course-Difference in English law between liquidated damages and penalty.

M agreed to purchase from S 4000 tons of rice and in pursuance of one of the terms of contract, instead of depositing any earnest money with the seller gave in lieu thereof a Bank guarantee to pay the amount of earnest money on his failure to fulfill his obligations under the terms of the contract. On failure of M to lift the goods within the stipulated time S sold the goods to a third party and by that transaction instead of suffering any loss, made a profit of Rs. 10,000. Thereafter, S filed a suit against M for recovery of the amount of earnest money on the basis of the Bank guarantee. On the question whether in view of the guarantee given by the Bank S was entitled to forfeit the amount covered by the guarantee and recover the same. On behalf of plaintiff S it was argued that he was entitled to claim the amount of earnest money irrespective of fact whether he suffered loss or not in the transaction in question:

Held, it will be wrong to argue that since the firm had agreed to deposit a sum as earnest money and in lieu there of furnished Bank guarantee for the said amount the Government would be entitled to claim the whole of this amount simply because there was a breach of the contract by the firm. Such a contention does not even receive support from the cases where the view taken was that the forfeiture clause of a deposit in a contract does not come within the purview of section 74 of the Contract Act. In these cases also forfeiture was held to be justified if the amounts were found to be reasonable.

Section 74 of the Contract Act does not recognize the difference that exists in the English law between liquidated damages and penalty. Under the Common Law a genuine pre-estimate of damages agreed upon by the parties is regarded as liquidated damages. But a stipulation in a contract in terrorem is a penalty. In the case of liquidated damages the contract is binding upon the parties. In the case of penalty, however, the Court refuses to enforce it and awards to, the aggrieved party reasonable compensation. The argument that section 74 of the Contract Act deals only with the right to receive from the party who has broken a contract reasonable compensation and not the right to forfeit what has already been received by the aggrieved party cannot be accepted in view of the terms of the section. The cases in which such a view has been taken appear to have ignored the expression "the contract contains any other stipulation by way of penalty" in the section. This expression is comprehensive enough to include cases of forfeiture of money or any property already delivered as well as cases of recovery of money or any property on the basis of a promise to pay.

It is difficult to see why a contract which contains a covenant for forfeiture of deposit actually made or an amount which is recoverable on failure to perform the contract will not come within the expression "if the contract contains any other stipulation by way of penalty". The award of compensation by the Court under section 74 of the Contract Act will depend upon its finding as to what in the facts and circumstances of the case is reasonable compensation subject to the limit of the amount mentioned in the contract. It is true that the aggrieved party is entitled to recover compensation from the party who is guilty of breach of the contract whether or not actual damage or loss is proved to have been, caused thereby.

In the present case the plaintiff instead of suffering any loss for the failure of the firm made a profit of Rs. 10,500. The question that arises, therefore, is whether in spite of the above fact the claim of the plaintiff in whole or in part can be justified. The Court was of the view that the plaintiff is not entitled to any part of its claim whether the term of the contract regarding forfeiture comes within the purview of section 74 of the Contract Act or not.

The Trustees of the Port of Karachi v. Ghulamali Habib Rawjee P L D 1961 Kar. 623 and W. J. Younie and others v. Tulsiram Jankiram and others A I R 1942 Cal. 362 not approved.

Howe v. Smith L R 1884 Ch. D 89; Stockloser v. Johnson (1954) 1 A E R 630 and Manepalli Satyanarayanamurthi v. Thommandra Erikalappa A I R 1926 Mad. 410 considered.

(b) Contract-Sale of goods-Earnest money-Need not necessarily be a tangible thing-"Bank guarantee" can be subject matter of earnest-Contract Act (IX of 1872), S. 74.

In pursuance of a contract of sale of goods the buyer did not deposit any amount as earnest money with the seller but in lieu thereof a Bank on behalf of the buyer gave an unconditional and irrevocable guarantee to pay the amount of earnest money on the failure of the buyer to fulfil his obligation under the terms of the contract. On the breach of contract by the buyer, the seller filed a suit for the recovery of the earnest amount mentioned in the Bank guarantee. The High Court while dismissing the suit held that the plaintiff' was not entitled to sue for the recovery of any promised amount of earnest money on the basis of the Bank guarantee. The Supreme Court on appeal disagreed with the view of the High Court that as there was no deposit the question of forfeiture of earnest money did not arise:

It was held that while there cannot be any dispute that an earnest ordinarily means a tangible thing including a deposit, it will be restricting its meaning too much if these only are said to be the subject-matter of earnest. The modern trend in commerce is to take extensive advantage of facilities offered by banks. It i3 more advantageous for buyers to furnish Bank guarantees than to make deposits of cash money as earnest for the fulfillment of the terms of contracts of purchase. The denial to the sellers of the right to forfeit the amounts covered by Bank guarantees in case of breach of contract by the purchasers would result in reversing the trend and that will be to nobody's interest.

W. J. Younie and others v. Tulsi Ram Jankiram and others A I R 1942 Cal. 382 and Farr Smith & Company Ltd. v. Messers Limited (1928) 1 K B 397 ref.

Muhammad Haleem, Assistant Advocate-General, West Pakistan instructed by Shafiq Ahmad, Senior Attorney for Appellant.

Fakhruddin G. Ebrahim and Ibrahim Ahmad, Advocates Supreme Court instructed by Yousuf Rafi, Attorney for Respondent No. 1.

A. A. Fazeel, Advocate Supreme Court instructed by K. A Ghani, Attorney for Respondent No. 2.

Date of hearing: 21st January 1969.

JUDGMENT

ABDUS ASATTAR, J. ------This certificated appeal by the Province of West Pakistan arises out of a suit for the recovery of Rs. 69,781-4-0. The facts of this case, stated in a short compass, are as follows: --

On 23rd April, 1951, respondent No. 1 Messrs Mistri & Patel Co., a firm (hereinafter called the firm), wrote to the Director of Civil Supplies, Government of Sind, Karachi, offering to purchase 4,000 to 5,000 tons of sugdasi broken rice for export at the rate of Rs. 33-4-0 per bag of 2½ maunds ex-godown, Karachi. The Director of Civil Supplies, on the 27th April 1951, wrote to the firm accepting the offer subject to the following conditions :-

(1) You shall have to accept any quantity up to 4000 tons for sugdasi broken rice offered to you by Government.

(2) Export of the broken rice will be allowed to you outside Pakistan subject to currency restrictions. You shall have to pay for exports in sterling if required to do so.

(3) The goods will be supplied to you on "as is where is" basis in the bags in which they are contained.

(4) Supplies will be made to you against payment and earnest money returned (or Bank Guarantee released) after you have completed the delivery.

(5) You shall have to credit 5 % of the total value of the goods immediately or give an unconditional Bank Guarantee in the draft form hereunto annexed.

(6) You shall have to lift the goods within three months from the date of this acceptance. If you fail to lift the goods within this period the earnest money deposit shall be forfeited or guarantee cashed and goods disposed of at your risk and cost.

(7) The goods shall be subject to Central and Provincial Government inspection at the time of export and Sind Government shall not be responsible if any difficulty arises at the time of export. No claim shall lie against Government on this or any account.

Mr. Ali Muhammad Patel, a partner on behalf of the firm, accepted these conditions on the 28th April 1951. Respondent No. 2 Mercantile Co-operative Bank (hereinafter called the Bank), gave an unconditional and irrevocable guarantee for the payment on demand to the Government of Sind of the earnest money deposit payable by the firm in the event of its failure to carry out the terms of the contract. Pursuant to the agreement the firm only took delivery of 1550 bags out of the contracted quantity of 4000 tons and failed to lift the balance of the good within the stipulated period. On being served with notice asking for the payment of the earnest money, the firm pointer out that it could not lift the goods within the contracted period on account of the notification of the Reserve Bank of India prohibiting export to Portuguese India with the Government of Whirl it had been negotiating for the, sale of the goods in question

The firm asked the permission of the Government either to sell the rice in Pakistan or to allow it to take delivery after it had secured offers from any country outside Pakistan. This request was turned down and the remaining bags of rice were sold on the 15th of November 1951, at the rate of Rs. 33-8-0 per bag to Messrs Habib Rouzi & Co., without any condition for export. By this transaction the Government, instead of suffering a loss made a profit of 0-4-0 per bag amounting to a total of Rs. 10,500. The present suit was filed on the 27th April 1951 for the recovery of Rs. 72,405-3-0 being the earnest money with interest at the rate of 6 % per annum from 27-7-1951 up to 27-4-1955.

The suit was resisted by the defendants. Their stand was that as no amount was paid as earnest money the question of forfeiture did not arise. The Bank guarantee was given for the purpose of compensating any loss if suffered for the default of the firm and as no loss had been incurred the Government was not entitled to recover anything from the respondents. Their further contention was that the plaintiff was not entitled to recover the earnest money as well as to sell the goods at the risk of the firm. In the present case as the plaintiff had made a profit by the sale after the failure of the defendant firm it was not entitled to claim the earnest money by enforcing the bank guarantee against the defendants.

The suit was tried on the original side of the High Court of West Pakistan, Karachi, Bench, and dismissed by a learned Single Judge mainly on the ground that the plaintiff was not entitled to sue for the recovery of any promised amount of earnest money. The learned Judge came to the conclusion that the agreement with the Bank was in the nature of a guarantee to reimburse the plaintiff for any loss to be suffered by it and as the plaintiff had not suffered any loss in the transaction in suit it was not entitled to claim anything from the Bank and for that matter from the firm. The Letters Patent Appeal filed against this decision was dismissed with costs.

The admitted facts of this case are that the firm did not deposit any amount with the then Government of Sind as earnest money. The Bank in lieu thereof, gave an unconditional guarantee to pay the amount of earnest money, on the failure of the firm to fulfill its obligations under the terms of the contract. The question that arises, therefore, is whether in view of the guarantee given by the Bank, the plaintiff was entitled to forfeit the amount covered by the guarantee and recover it from the defendants.

The learned counsel for the appellant has contended that the non deposit of the earnest money by the firm does not affect the question whether the plaintiff can forfeit the amount to be so deposited as earnest money. In support of this contention reliance has been placed on the case of W. J. Younie and others v. Tulsi Ram Jankiram and others (A I R 1942 Cal. 382). In this case it has been observed "where the defendant is to pay a security deposit under the contract and he is to forfeit that deposit in case of a breach, his failure to pay the security deposit cannot affect the question whether the plaintiff is entitled to recover or to forfeit the deposit amount. That question can be approached in the same way as if such deposit had been paid to and retained by the plaintiff and the defendant was claiming its return."

In the case of Farr. Smith and Company, Limited v. Messers Limited ((1928) 1 K B 397) Wright, J. observed:

> "An earnest must be a tangible thing, in which definition it may be that a deposit is included, but in the old cases it was always some tangible thing. That thing must be given at the moment at which the contract is concluded, because it is something given to bind the contract, and therefore, it must come into existence at the making or conclusion of the contract. The thing given in that way must be given by the contracting party who gives it, as an earnest or token of good faith, and as a guarantee that he will fulfil his "contract, and subject to the terms that if, owing to his default, the contract goes off, it will be forfeited. If, on the other hand, the contract is fulfilled, an earnest may still serve a further purpose and operate by way of part payment."

While there cannot be any dispute that an earnest ordinarily means a tangible thing including a deposit, it will be restricting its meaning too much if these only are said to be the subject-matter of earnest. The modern trend in commerce is to take extensive advantage of facilities offered by banks. It is more advantageous for buyers to furnish Bank guarantees than to make deposits of cash money as earnest for the fulfillment of the terms of contracts of purchase. The denial to the sellers the right to forfeit the amounts covered by Bank guarantees in case of breach of contract by the purchasers would result in reversing the trend and that will be to nobody's interest.

In the present case the guarantee by the Bank was given in these terms :-

> "We have therefore the pleasure of informing you that we hereby unconditionally guarantee the payment on demand to the Government of Sind, of the earnest money deposit payable by the said Messrs Mistry & Patel Co., amounting to Rs. 75,000 with the interest at the rate of 6% per annum from the date of Government's acceptance of tender. In the event of the said Messrs Mistry & Patel Co., failing to discharge their obligations to the Government of which failure and the extent thereof of the Government of Sind, will be the sole Judge. We also agree that this guarantee will be irrevocable until the said Messrs Mistry & Patel Co., have wholly discharged their obligations with the Government in confirmity with the conditions of their contract to the satisfaction of the Government."

We are, therefore, unable to agree with the view taken by the High Court that as there was no deposit the question of for feiture of the earnest money did not arise. The contract clearly gave the Government the right to forfeit the earnest money in case of failure and it would be wrong to hold that the right could not be exercised against the guarantor. This finding however, does not conclude the matter.

The real question that falls for determination is whether in the fact and circumstances of this case the Bank Guarantee could be enforced for the failure of the firm to lift 2450 bags of rice within the stipulated period. Mr. Haleem, on behalf of the appellant, has argued that the Government was entitled to claim the amount of earnest money irrespective of the fact whether it suffered loss or not in the transaction in question. In support of this contention he has relied on the case of Howe v. Smith (L R 1884 Ch. D 89). The headnote of the case, which summarises the decision correctly, reads as follows :-

"On a sale of real estate the purchaser paid £. 500, which stated in the contract to be paid as a deposit, and in part payment of the purchase money". The contract provided that the

purchase should be completed on a day named, and that if the purchaser should fail to comply with the agreement the vendor should be at liberty to re-sell and to recover any deficiency in price as liquidated damages. The purchaser was not ready with his purchase-money, and, after repeated delays, the vendor re-sold the property for the same price.

The original purchaser having brought an action for specific performance, it was held by the Court of Appeal, arming the decision of Kay, J., that the purchaser had lost by his delay his right to enforce a specific performance :-

Held, also, that the deposit, although to be taken as part payment if the contract was completed, was also a guarantee for the performance of the contract, and that the plaintiff, having failed to perform his contract within a reasonable time, had no right to a return of the deposit."

We, however, find that in somewhat similar circumstances Denning, L. J. in the case of Stockloser v. Johnson ((1954) 1 A E R 630), observed as follows

"When there is no forfeiture clause, if money is handed over in part payment of the purchase price, and then the buyer makes default as to the balance, then, so long as the seller keeps the contract open and available for performance, the buyer cannot recover the money, but once the seller rescinds the contract or treats it as at an end owing to the buyer's default, then the buyer is entitled to recover his money by action at law, subject to a cross-claim by the seller for damages: See Palmer v. Temple (10), Mayson v. Clouet (11), Dies v. British & International Mining & Finance Corpn., Ltd. (3), and Williams on Vendor and Furchaser, 4th Ed., Vol. 2, p. 1006. (ii) But when there is a forfeiture clause or the money is expressly paid as a deposit (which is equivalent to a forfeiture clause), then the buyer who is in default cannot recover the money at law at all. He may, however, have a remedy in equity, for, despite the express stipulation in the contract, equity can relieve the buyer from forfeiture of the money and order the seller to repay it on such terms as the Court thinks fit. That is, I think, shown clearly by the decision of the Privy Council in Steedman v. Drinkle, where the Board consisted of a strong three, Viscount Haldane, Lord Parker of Waddington, and Lord Sumner. The difficulty is to know what are the circumstances which give rise to this equity, but I must say that I agree with all that Somervell, L. J., has said about it, differing herein from the view of Romer, L. J. Two things are necessary : first, the forfeiture clause must be of a penal nature, in the sense that the sum forfeited must be out of all proportion to the damage ; and secondly, it must be unconscionable for the seller to retain the money."

A similar view has been taken in the case of The Trustees of the Port of Karachi v. Ghulamali Habib Rawjee (P L D 1961 Kar 623). It was observed :-

"Normally in a contract of sale of immovable property the seller is, upon a breach by the purchaser, entitled to forfeit the earnest money or a deposit of the same character. But in cases in which from the consideration of all the relevant s circumstances the forfeiture and the retention of the amount by seller would be unconscionable, the Court would upon equitable principles intervene and grant relief to the defaulting purchaser. In order that this may be done it is not enough that the amount of the deposit appears to be unreasonable having regard to its proportion to the sale price, because what is reasonable must normally be determined by the parties at the time of the contract. Therefore, it must

be found that the retention of the amount by the seller would be unconscionable having regard to all the circumstances of the case. It may be that in a certain case the amount described as a deposit may itself be so exorbitant that the inference may become irresistible that it is really in the nature of a penalty in the event of default, for equity looks to the substance and not to the form. In determining whether the forfeiture is unconscionable the Court will take into consideration the nature of the contract, the conduct of the parties and the proportion of the amount of deposit to the sale price. Where the purchaser has not merely defaulted but has repudiated the contract and his conduct suffers from impropriety the Court will refuse to come to his aid, because one who seeks equity must come, with clean hands. On the other hand, the fact that the seller has sharply exercised his right or has obtained an unfair advantage though acting within his right under law would be taken into consideration in favour of granting relief to the purchaser."

We are, therefore, unable to accept the argument of the learned counsel for the appellant that simply because there was a forfeiture clause in the agreement the plaintiff was entitled to the amount covered by the Bank Guarantee irrespective of any other consideration. It has been rightly observed in the case of Manepalli Satyanarayanamurthi v. Thommandra Erikalappa (A I R 1926 Mad. 410), that it is never the practice in Mercantile Contracts to hold that whatever be the damage suffered or not suffered the seller is to be entitled to keep the deposit.

In the case of The Trustees of the Port of Karachi v. Ghulamall Habib Rawjee it has been held that section 74 of the Contract Act does not apply to a case of forfeiture of earnest money or of a deposit in the nature of earnest money. The relevant portion of the section reads as follows :-

> "When a contract has been broken, it" a sum is named in the contract as the amount to be paid in case of such breach, or if the contract contains any other stipulation by way of penalty, the party complaining of the breach is entitled, whether or not actual damage or loss is proved to have been caused thereby, to receive from the party who has broken the contract reasonable compensation not exceeding the amount so named or, as the case may be, the penalty stipulated for."

Section 74 of the Contract Act does not recognise the difference that exists in the English law between liquidated damages and penalty. Under the Common Law a genuine pre-estimate of damages agreed upon by the parties is regarded as liquidated damages. But a stipulation in a contract in terrorem is penalty. In the case of liquidated damages the contrac is binding upon the parties. In the case of penalty, however, the Court refuses to enforce it and awards to the aggrieved party reasonable compensation.

The argument that section 74 of the Contract Act deals only with the right to receive from the party who has broken a contract reasonable compensation and not the right to forfeit what has already been received by the aggrieved party cannot be accepted in view of the terms of the section. The cases in which such a view has been taken appear to have ignored the expression "the contract contains any other stipulation by way of penalty" in the section. This expression is comprehensive enough to include cases of forfeiture of money or any property already delivered as well as cases of recovery of money or any, property on the basis of a promise to pay.

The cases reported in A I R 1942 Cal. 382 and P L D 1961 Kar. 623 have proceeded on the view that section 74 of the Contract Act has no application to a case of forfeiture of earnest money or of a deposit which is in the nature of earnest money as the section deals only with a class of cases where the contract names a sum to be paid in case of breach. In our view the learned Judges who decided these cases did not, with due respect, we may point out, take into account another class of cases which come under the expression "the contract contains any other stipulation by way of penalty". It is difficult to see why a contract which contains a covenant for forfeiture of deposit actually made or an amount which is recoverable on failure to perform the contract will not come within the expression "if the contract contains any other stipulation by way of penalty". The award of compensation by the Court under section 74 of the Contract Act will depend upon its finding as to what in the facts and circumstances of the case is reasonable compensation subject to the limit of the amount mentioned in the contract. 1t is true that the aggrieved party is entitled to recover compensation from the party who is guilty of breach of the contract whether or not actual damage or loss is proved to have been caused thereby.

In the present case we are, therefore, to see whether the Province of West Pakistan can claim the whole or any part of the amount which the firm was to deposit by way of earnest money. It will be wrong to argue that since the firm had agreed to deposit a sum as earnest money and in lieu thereof furnished Bank Guarantee for the said amount the Government would be entitled to claim the whole of this amount simply because there was a breach of the contract by the firm. Such a contention does not even receive support from the cases where the view taken was that the forfeiture clause of a deposit in a contract does not come within the purview of section 74 of the Contract Act. In these cases also forfeiture was held to be justified if the amounts were found to be reasonable.

In the present case we have already seen that the plaintiff instead of suffering any loss for the failure of the firm made a profit of Rs. 10,500. The question that arises, therefore, is whether in spite of the above fact the claim of the plaintiff in whole or in part can be justified. We are of the view that the plaintiff is not entitled to any part of its claim whether the term of the contract regarding forfeiture comes within the purview of section 74 of the Contract Act or not. We have, therefore, found no reason to interfere with the decisions of the Courts below.

The appeal, therefore, is dismissed with costs.

K. B. A.

Appeal dismissed.