

# The Liquidated Damages Clause in Malaysia Today\*

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In construction contracts, it is very common to see standard form provisions or bespoke terms providing for liquidated damages. However, what the parties often fail to consider are the implications of such clauses that appear in the contract. Is the liquidated damages clause to be treated as a genuine pre-estimation of loss and damages, or merely as an aid to justify the reasonableness of the stipulated sums or formula? Or any sum stipulated should be negated and the innocent party bears the burden of proving actual loss and damages?

## Two schools of thought

Historically, there have been conflicting authorities on whether it is permissible to adopt a liquidated damages clause in a construction contract *simpliciter* and, if so, for what purpose. One school of thought, predominant in Malaysia, is that such a clause should not be taken account of at all; any sum stipulations or formula are to be treated as if they are penal in nature and should not therefore be enforceable. In contrast, there is also a line of international authorities in support of the position that liquidated damages clauses, being a pre-agreed method of compensation, should be enforceable unconditionally, or at least that the court is entitled to consider if any assistance can be derived from them in assessing the reasonableness of the clause.

Liquidated damages are a genuine attempt by the parties, at the time of contract, to pre-estimate compensation for the probable damage that will result from a breach of contract. A clause is penal if it is not intended to compensate for reasonable loss but rather to stipulate a consequence which is calculated to deter a party from breaching a contract. In common law jurisdictions, liquidated damages clauses are enforced as of right, while penalty clauses are

struck down and the innocent party is required to prove its actual loss.

However, in Malaysia, by reason of s 75 of the Contracts Act 1950 ("the CA 1950"), the common law distinction between liquidated damages and penalties is abolished, and the innocent party claiming damages must prove its *actual loss* as if the provision was a penalty. Further, it bears noting that while common law looks at conceptual loss, as anticipated at the time of contract, s 75 requires an examination of the actual losses suffered at the time of breach.

Therefore, relying on the principles enunciated in *Selva Kumar*<sup>1</sup> and *Johor Coastal Development*,<sup>2</sup> it is trite that an innocent party intending to rely on liquidated damages clause must:

- (i) establish that there was a breach of contract;
- (ii) prove the fact of "*actual damage*" (although not necessarily the quantum of its loss);
- (iii) justify the reasonableness of the stipulated sum or formula:
  - (a) If the quantum of actual or real loss is capable of assessment, the innocent party will be entitled to such damages. If the innocent party fails to produce evidence to prove the loss which is capable of being so assessed, only nominal damages will be awarded; and
  - (b) If the innocent party shows that it suffered some "actual damage" for which "there is no known measure of damages employable, and yet the evidence clearly shows some real loss inherently which is not too remote",<sup>3</sup> then the judge would be required to assess and determine a reasonable compensation.

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1 *Selva Kumar a/l Murugiah v Thiagarajah a/l Retnasamy* [1995] 2 CLJ 374 (FC)

2 *Johor Coastal Development Sdn Bhd v Constrajaya Sdn Bhd* [2009] 4 CLJ 569 (FC)

3 *Ibid*, at p 584 para 25(3)

- (iv) ensure the sum stipulated in the liquidated damages clause is not an entitlement, but rather a limitation of the innocent party's rights to compensation.

### **Cubic Electronics**

In the recent case of *Cubic Electronics*,<sup>4</sup> the Federal Court, in considering issues relating to an earnest deposit, discussed extensively the application of s 75 of the CA 1950 and its effect on liquidated damages clauses.

Cubic Electronics was the owner of a piece of land in Melaka, along with plant and machinery on the property. Following the winding up of Cubic Electronics, the assets were put up for sale by way of an open tender exercise.

Before the open tender exercise could go through, Mars Telecommunications made an offer to purchase the assets for RM90 million, and paid an initial earnest deposit of RM1 million. The liquidator accepted Cubic Electronics' offer and did not therefore proceed with the open tender exercise.

The acceptance of the offer was subject to the terms contained in the information memorandum, which provided that the sales must be executed within a fixed time frame, failing which the earnest deposit of RM1 million paid would be forfeited as liquidated damages and not by way of penalty. Mars Telecommunications failed to execute the sale and purchase agreement within the requisite time frame.

It then repeatedly requested extension of time, by paying further earnest deposits and interest. The total earnest deposit paid by Mars Telecommunication amounted to some RM3 million.

Notwithstanding the many extensions, Mars Telecommunication failed to execute the sale and purchase agreement. Consequently, the liquidators terminated the intended sales arrangement and forfeited the entire sum of RM3 million paid as earnest deposit for the total

consideration of RM90 million. Eventually, the assets were sold to a third party through an open tender exercise.

Mars Telecommunications disputed the termination of sales arrangement and forfeiture of earnest deposit paid, and commenced legal proceedings at the High Court. The court held that the termination was valid and, therefore, Cubic Electronics had rightfully forfeited the total earnest deposit paid, without having to prove the actual loss incurred or damages suffered.

Applying the principles in *Selva Kumar* and *Johor Coastal*, the Court of Appeal reversed the decision of the High Court and held that, save for the initial earnest deposit of RM1 million, Cubic Electronics must, but failed to, prove the actual damage suffered or that the same was reasonable compensation pursuant to s 75 of the CA 1950.

Dissatisfied with the Court of Appeal's findings, Cubic Electronics appealed to the Federal Court.

The Federal Court reversed the decision of the Court of Appeal and reinstated the decision of the High Court. In its lengthy judgment, the Federal Court carefully considered the jurisprudence on the application of s 75 of the CA 1950, and formulated the following principles, applicable for interpretation of a liquidated damages clause:

1. Upon establishing a breach of contract, the sum stipulated in the liquidated damages clause is subject to s 75 of the CA 1950.
2. Section 75 allows reasonable compensation to be awarded by the court irrespective of whether actual loss or damage is proven. Thus, proof of actual loss is not the sole conclusive determinant of reasonable compensation although evidence of that may be a useful starting point.
3. A sum payable on breach of contract will be held to be unreasonable compensation if it is

<sup>4</sup> *Cubic Electronics Sdn Bhd v Mars Telecommunications Sdn Bhd* (FC) [Appeal No 02(f)-64-09/2016(W)]. The grounds of judgment may be viewed here: [http://ejudgment.kehakiman.gov.my/ks\\_builtin/file\\_dispatcher\\_pub.php?id=5702&key=ed81b0402ba712ac3684a25c32aa5d6f](http://ejudgment.kehakiman.gov.my/ks_builtin/file_dispatcher_pub.php?id=5702&key=ed81b0402ba712ac3684a25c32aa5d6f)

extravagant and unconscionable in amount in comparison with the highest conceivable loss which could possibly flow from the breach. In the absence of proper justification, there should not be a significant difference between the level of damages spelt out in the contract and the level of loss or damage likely to be suffered by the innocent party.

The newly propounded principles reverse the onus of proof by requiring the defaulting party to prove the unreasonableness of the liquidated damages clause including the sum stated therein, if any.

Once the two elements have been established, the innocent party is entitled to receive a sum not exceeding the amount stipulated in the contract, irrespective of whether actual damage or loss is proven, unless the defaulting party proves the unreasonableness of the liquidated damages clause including the sum stated therein.

### Conclusion and practice points

Given that this latest decision appears to allow liquidated damages clauses to be enforced unconditionally in certain circumstances, careful thought should be given to the drafting of such clauses specifically in major construction contracts.

From a practical point of view, the clear shift in Malaysian judicial attitude towards respecting the parties' freedom of contract, especially if the contracting parties have comparable bargaining power and are properly advised, is to be welcomed. This sensible approach focuses the parties' attention, from an early contracting stage, on what are likely to be the relevant issues and risks, and promotes legal certainty in the application of the liquidated damages clauses.

In drafting liquidated damages clauses, there are several points to remember:

- While you may no longer be required to prove actual loss at the outset, if disputed by the defaulting party, you may still have to justify the reasonableness of the liquidated damages clause, which could best be proved through evidence of actual loss.
- Therefore, documenting and recording extra costs incurred and damages suffered may still be advisable.
- Ensure that any entitlement you will have on the defaulting party's breach is proportionate to your interest in enforcing performance.
- It may also be a good idea to discuss and record the basis of quantification so as to document the reasonableness of the stipulation. This may preempt future litigations on the reasonableness of the liquidated damages clause.
- Caution must still be exercised not to stipulate a seemingly exorbitant sum or formula. **LH-AG**

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