Liquidated Damages: The Taming of Section 75

by Steven S Y Tee and Joyce Ong Kar Yee

English (and Malaysian) common law prides itself on its embrace of the principle of freedom of contract. Parties can freely agree on the terms of their contract on the basis that what is not prohibited by law is permitted. An example of a legal restriction on this freedom is the unenforceability of any obligation to pay liquidated damages where it amounts to a penalty. The distaste for penalties originated in equity when it granted relief against the harshness of penal bonds. Historically, a penal bond was an instrument that required the obligor to pay a specified sum of money as penalty if the separate underlying obligation was not performed by a certain date. For example, A loans B RM100 and B executes a bond to pay RM200 to A on a stipulated day. B will then owe A RM200 under the bond if B does not repay the loan of RM100 on or before such stipulated date.

Courts of equity regarded penal bonds as security for performance of the underlying obligation and were prepared to restrain enforcement of such bonds where the defaulting party paid any damages due at common law. This rule was subsequently adopted by the common law and reinforced by statute.[1]

Commercial contracts often contain liquidated damages clauses which may take a number of different forms. In construction contracts, this would usually involve the payment of a pre-determined sum (being either a fixed figure or an amount to be calculated using an agreed formula) by a defaulting party as agreed compensation for the breach.[2] Prior to 2015, the test under English law for determining whether a liquidated damages clause would be enforceable was whether the agreed compensation is a "genuine pre-estimate of loss"[3] likely to be caused by the breach and therefore compensatory in nature.

Subsequently, however, in *Cavendish*,[4] the UK Supreme Court revisited this century long-held position and stated that:

> "The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation."[5]

> "What is necessary in each case is to consider, first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether, assuming such an interest to exist, the provision made for that interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable."[6]

This indicates a shift in focus from considering the compensatory purpose of the clause to whether it is reasonable deterrence to protect a legitimate interest. The new test means that a liquidated damages clause would not be considered to be an unenforceable penalty, if:

(i) there is a legitimate business interest to be protected in the enforcement of a primary obligation which is not satisfied by the usual damages claim; and

(ii) the liquidated damages payable for breach of the primary obligation are not disproportionate to such interest, extravagant or unconscionable.

1 The enactment of the English Administration of Justice Act of 1705 allowed the defendant in an action on the bond to pay the amount of the actual loss, together with interest and costs, into court, and rely on the payment as a defence.
2 Other forms of agreed compensation include the withholding of a payment otherwise due by the non-defaulting party or the forced transfer of an asset by the defaulting party.
3 *Dunlop Pneumatic Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79 at 82
4 *Cavendish Square Holding BV v Talal El Makdessi* [2015] UKSC 67
5 *Ibid* at 17, para 32
6 *Ibid* at 71, para 152

It is often not easy to properly quantify in advance the expected loss resulting from breach. Liquidated damages clauses may, in that respect, be more likely to be upheld under the new test since the amount payable need only not be disproportionate, extravagant or unconscionable.

Cubic revision

Malaysian courts have also now taken what appears to be a more liberal view on the enforceability of liquidated damages clauses. Unlike English law, Malaysia has its Contracts Act 1950, which provides in s 75 that:

> "When a contract has been broken, if 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."

The rule against penalties in Malaysian contract law is therefore codified and applies differently. Until recently, the established interpretation of s 75 was laid out by the Federal Court in *Selva Kumar*.[7] This decision held that if the loss resulting from the breach was measurable, then the claimant seeking to enforce payment of liquidated damages would have to prove such loss. Where the loss was difficult to measure, then the courts would award reasonable and fair damages. In either case, the amount of damages payable will not exceed the stipulated contractual amount or penalty.[8]

This position has now been revised by the Malaysian Federal Court in *Cubic*.[9] The difficulty with the *Selva Kumar* decision was that it did not sit well with the plain and ordinary reading of s 75, particularly the words "whether or not actual damage or loss is proved to have been caused thereby". These words may have been added "without seemingly any thoughtfulness about the desirability of some appropriate limitations",[10] as remarked by the court in *Selva Kumar*. Nonetheless, they seem quite unequivocal in their meaning. The court in the *Cubic* case seems to have accepted that these words should now simply be applied in accordance with their plain meaning.

It was held in *Cubic* that:

(a) reasonable compensation will be awarded whether actual loss or damage is proven, although proof of actual loss will be a useful starting point;

(b) a sum payable on breach of contract will be unreasonable compensation if it is extravagant and unconscionable in amount in comparison with the highest conceivable loss which could possibly flow from the breach;

(c) the concepts of "legitimate interest" and "proportionality" as enunciated in *Cavendish* are relevant in determining what amounts to reasonable compensation;

(d) once the claimant has established a contractual breach and the existence of a liquidated damages clause, it would prima facie be entitled to receive a sum not exceeding the stipulated amount;

7 *Selva Kumar a/l Murugiah v Thiagarajah a/l Retnasamy* [1995] 1 MLJ 817 (FC)
8 *Ibid* at 829
9 *Cubic Electronics Sdn Bhd (in liquidation) v Mars Telecommunications Sdn Bhd* [2019] 1 AMR 737; [2018] MLJU 1935
10 *Selva Kumar, supra* n 7 at 827

(e) if there is a dispute as to what constitutes reasonable compensation, the defaulting party would have to prove that the liquidated damages clause, including the stipulated amount is unreasonable.

On the face of it, no distinction will now need necessarily be made between cases where loss is measurable and where it is not, as proof of loss is no longer the sole conclusive determinant of reasonable compensation. A claimant is not necessarily restricted to an award of actual loss where loss is measurable. This is consistent with the express language of s 75. However, in practice, proof of loss may still be required to rebut any of the defaulting party's arguments that the liquidated damages clause or amount is unreasonable. In addition, the court, in applying the above principles, would have to make an initial determination whether the stipulated amount is reasonable, subject to the defaulting party proving otherwise. A claimant should then sensibly be prepared to prove its actual loss to support the reasonableness of such amount.

'Reasonable compensation'

Interestingly, the court has now imported the principles in *Cavendish* mentioned above in interpreting "reasonable compensation" under s 75. At first glance, this seems somewhat philosophically odd. The current English position reflects an acceptance that liquidated damages are aimed to secure performance, while s 75, by permitting only "reasonable *compensation*" be given, must necessarily be concerned about making good the loss in some way. It is not entirely clear from *Cubic*, but where the loss is measurable, it may be that whether the agreed compensation is reasonable should simply be determined by comparing the actual likely loss and the stipulated amount. Presumably, the *Cavendish* principles would then only apply where the loss is difficult to measure. This suggests that the distinction between cases where loss is measurable and where it is not, remains relevant.

Liquidated damages are a helpful commercial device for parties to allocate risks and responsibilities in a transparent and certain manner. Their use minimises potential disputes between themselves. Both the *Cavendish* and *Cubic* decisions have expanded the scope of freedom of contract in this area. They should, therefore, be much welcomed.

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