

Client Alert

January 2019

Shift in Position of Liquidated Damages in Malaysia - Section 75 of the Contracts Act 1950

*Cubic Electronics Sdn. Bhd. (In Liquidation) v MARS Telecommunications Sdn. Bhd.*¹

General Position of Section 75

The general position in Malaysia under Section 75 of the Contracts Act 1950 ("**Section 75**") has always been that where there is a breach of contract, an innocent party cannot recover simpliciter the sum fixed in a damages clause regardless of whether it is stipulated as a penalty or liquidated damages. The innocent party must prove the actual damage he has suffered unless his case falls under the limited situation where it is difficult to access actual damage or losses.²

Background Facts

The Appellant was the owner of a piece of land together with certain plant and machinery on the land (collectively known as "the properties"). The Appellant went into liquidation and as part of the liquidation process, the properties went up for sale. Subsequently, the Respondent offered to purchase the properties and was required to pay an earnest deposit. In addition, the acceptance of the Respondent's offer was conditional upon the sale and purchase agreement ("SPA") for the properties being executed within 30 days failing which the earnest deposit paid by the Respondent would be forfeited in favour of the Appellant.

The Respondent failed to execute the SPA by the stipulated timeline and requested an extension (the "first extension"). This first extension was granted but the Respondent was required to pay a further earnest deposit to the Appellant. The Appellant cautioned that such earnest deposit will be forfeited as agreed liquidated damages if there was another failure to comply with the deadline to execute the SPA. Subsequently, a further three requests for extension was made by the Respondent. The second and third extensions were granted on the same condition that further earnest deposits be paid to the Appellant. Pursuant to the fourth request for extension (the "fourth extension"), the Appellant similarly required the Respondent to pay further earnest deposit, but this time there was an additional requirement for a non-refundable interest on the balance of the deposit for the properties.

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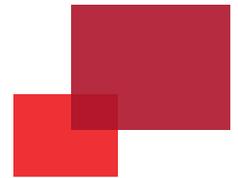
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¹ Appeal No. 02(f) - 64 - 09/2016(W).

² See *Selva Kumar Murugiah v Thiagarajah Retnasamy* [1995] 1 MLJ 817, approving the Privy Council decision in *Bhai Panna Singh v Bhai Arjun Singh* AIR 1929 PC 179.



The Respondent still failed to meet the extended deadline pursuant to the fourth extension and the Appellant terminated the sale. The Appellant thereafter duly forfeited all the earnest deposits paid by the Respondent together with the non-refundable interest.

An action was then brought by the Respondent against the Appellant for wrongful termination and sought for return of the deposit money and interest paid.

The Respondent's claim was dismissed by the High Court. On appeal, the Court of Appeal ruled that the forfeiture of the entire deposit and interest was impermissible but allowed the forfeiture of the first earnest deposit. The Court of Appeal referred to ***Selva Kumar a/l Murugiah v Thiagarajah Retnasam***³ and ***Johor Coastal Development Sdn Bhd v Constrajaya Sdn Bhd***⁴ and held that there was no evidence to show the Appellant suffered the impugned amount due to the Respondent's breach and neither was the amounts forfeited a genuine pre-estimate of loss as required under Section 75.

The Appellant appealed. The Federal Court allowed the appeal by reinstating the order of the High Court and in doing so, shifted the position that has been so well ingrained in the industry for the past 30 years.

New Position

Deposits

In dealing with the Respondent's contention that the payments are not true deposits but penalties which are caught by Section 75, the Federal Court held that if there is a breach of contract, any money paid in advance of performance and as part-payment of the contract price is generally recoverable by the payer.⁵ However, a deposit paid which is not merely part payment but also as a guarantee of performance is generally not recoverable.⁶ If a payment possesses the dual characteristics of earnest money and part payment, it is a deposit. The Federal Court followed the courts in the United Kingdom and India which have held that the principles of law on damages clause are equally applicable to forfeiture of deposits. Thus, Section 75 is applicable to the forfeited deposit in the current case.

Proof of Loss or Damage

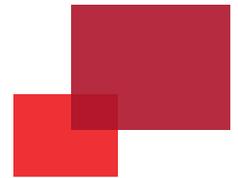
Pertinently, the Federal Court opined that it is not necessary for the innocent party to prove his/her actual loss or damage in every case. ***Selva Kumar*** and ***Johor Coastal*** should not be interpreted to mean that proof of actual loss is the sole conclusive determinant of reasonable compensation. Reasonable compensation is not confined to actual loss, although such evidence may be a useful starting point.

³ See footnote 2.

⁴ [2009] 4 CLJ 569.

⁵ See *Dies v British and International Mining and Finance Co* [1939] 1 KB 715.

⁶ See *Howe v Smith* (1884) 27 Ch D 89.



It was further laid down that the concepts of "legitimate interest" and "proportionality" as enunciated in ***Cavendish Square Holding BV v Talal El Makdessi***⁷ are relevant in deciding what amounts to "reasonable compensation" under Section 75. The courts must first consider whether any "legitimate commercial interest" in performance extending beyond the prospect of pecuniary compensation flowing from the breach is served or protected by a damages clause and then evaluate whether the provision made for the interest is proportionate to the interest identified. Ultimately, the central feature of both the ***Cavendish*** case and Section 75 is the notion of reasonableness.

It should also be noted that Section 75 provides that reasonable compensation must not exceed the amount so named in the contract. As such, the damages clause that the innocent party seeks to uphold would function as a cap on the maximum recoverable amount.

The Federal Court went on further to state that if there is a dispute as to what constitutes reasonable compensation, the burden of proof then falls on the defaulting party to show that the damages clause including the sum stated is unreasonable. A sum will be held to be unreasonable if it is extravagant and unconscionable in comparison with the highest conceivable loss which could possibly flow from the breach.

Conclusion

Parties seeking to enforce a damages or liquidated clause must essentially:

- (a) prove there was a breach of contract; and
- (b) the contract contains a damages or liquidated clause which stipulates a sum to be paid in the case of a breach.

The amount claimable is also subject to the maximum amount stated in the contract.

If the defaulting party feels that the compensation/damages stipulated under the contract is unreasonable, the burden is on the defaulting party to prove that such sum is unreasonable.

Owners and employers can now be comforted that the new position looks favourable to them in the sense that such clauses on deposits or liquidated damages, if challenged in court in terms of enforceability, would have better chances of success in withstanding such challenges.

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⁷ [2015] UKSC 67.