

## Recovery of Liquidated Damages in Malaysia-Legal Pitfalls and the Way Forward

Tan Pei Meng and Ong Seng Fook  
Faculty of Accountancy and Management,  
Universiti Tunku Abdul Rahman, Kajang, 43000 Selangor, Malaysia

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**Abstract:** This study examines the law relating to recovery of liquidated damages in Malaysia. Judicial decisions on this area of law are assessed to determine the possible legal pitfalls faced by an aggrieved party. A legal comparison is also undertaken in relation to the different approaches taken in other countries. This study goes on to determine whether the Malaysian courts should take a different approach in determining the recovery of damages clause and whether it is possible to adopt such approach within the existing legal framework under the Malaysian Contracts Act.

**Key words:** Liquidated damages, contracts, S. 75 Contracts Act 1950, country, courts

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### INTRODUCTION

A contract is the instrument which fixes the rights and obligations of the contracting parties. The determination of the contents of the contract would depend on what they decide to suit their best interests. As such, the law recognizes that they have the freedom of contract to draft the contractual provisions as long as the provisions do not go against the law and public policy. Throughout the years, many contractual provisions are introduced to enhance the efficiency of the performance of the contract as well as the settlement of legal disputes arising from such contracts. One such clause introduced is the Liquidated Damages Clause (LDC). This is often described as a contractual term agreed upon by both the contracting parties which stipulates the amount of damages payable upon a breach of contract. Such a clause has received legal acknowledgment due to the benefits arising from its utilization. The existence of a LDC assists the contracting parties to compare the cost/risk and benefits of the performance of the contract to determine whether the contract is worth pursuing. It also saves time and cost in the dispute resolution of a breach of contract where it exclude the need for the courts to determine the amount of damages payable. This would be most useful in relation to situations where it might be difficult for the aggrieved party to prove the amount of losses suffered.

There are two issues which arise from the recovery of liquidated damages, i.e., whether the LDC is enforceable and if so, what is the amount which can be recovered. The objective of this study is to examine the legal position of recovery of liquidated damages in Malaysia, particularly,

the legal pitfalls which any business entity or consumer should be aware of in order to prevent getting trapped by these pitfalls which would seriously jeopardize their changes of claiming for liquidated damages.

### SECTION 75 CONTRACTS ACT 1950 (ACT 136)

The recovery of liquidated damages in Malaysia is governed by S. 75 which states 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 (emphasis added)

The main issue in relation to the interpretation of S. 75 is on determining the meaning intended for the phrase 'whether or not actual damage or loss is proved to have been caused thereby' ('the phrase'). This was resolved by the Supreme Court in *Selva Kumar a/l Murugiah v Thiagarajah*. In this case, the legal dispute arose from the failure of the purchaser of a clinic to pay its purchase price in full. At the time of default, he had paid RM96,000 out of the purchase price of RM120,000. The vendor sought to forfeit the RM96,000 in pursuant to

Clause 15(b) of the sale and purchase agreement which provided that the RM96,000 'shall be forfeited absolutely to the vendor as agreed liquidated damages'.

It was held that the S. 75 must be given a restrictive interpretation. As a general rule, a party who seeks to enforce a LDC has to prove the actual damages or the reasonable compensation in accordance with S. 74 Contracts Act 1950 which provides the scope of the types and amount of damages recovered from a legal action for breach of contract. Otherwise, no recovery of liquidated damages is allowed. The only exception is in relation to situations where the court finds it difficult to assess damages for the actual damage as there is no known measure of damages employable and yet the evidence clearly shows some real loss which is not too remote. In these circumstances, the Supreme Court advises that the court ought to award substantial damages as opposed to nominal damages which are reasonable and fair according to the court's good sense and fair play.

On the facts of Selva Kumar, it was held that losses arising from such a breach of contract (failure to pay which results in the loss of use of the medical equipment by the vendor) could be assessed by settled rules. Since, the vendor did not prove any losses, he could only retain RM12,000 as forfeiture of deposit and had to return the balance amount to the purchaser.

The correctness of the decision of Selva Kumar was affirmed by the Federal Court in *Johor Coastal Development Sdn Bhd v Constrajaya Sdn Bhd* which seems to hit the final nail to the coffin of any differing arguments on the decision of Selva Kumar.

#### **LEGAL EFFECTS AND PITFALLS OF RECOVERY OF LIQUIDATED DAMAGES**

This part will sum up legal principles involved in the recovery of liquidated damages in Malaysia as well as its legal pitfalls. As a result of S. 75, in Malaysia, there is no distinction between a LDC and a penalty. Any determination as to whether a term of a contract providing for agreed damages is a LDC or a penalty is redundant. Hence, the key issue is on the amount that can be claimed by the aggrieved party. The courts have the discretion to award any other amount, the highest being the amount stated in the term as liquidated damages. There is therefore no guarantee that a party claiming for liquidated damages would be entitled to the exact amount as stated in the LDC.

As a consequence, it becomes necessary for the aggrieved party to determine how he can claim the full amount in the LDC. Although, the guidance for doing so

is provided by Selva Kumar, it is submitted that there remains a number of uncertainties faced by the aggrieved party in ensuring that he can recover the full amount. It must be noted that if the amount of the liquidated damages is not disputed in a legal action, the courts would allow the recovery of the liquidated damages in pursuant to the LDC.

Legal practitioners have come up with arguments or contractual clauses to ease the difficulties faced by their clients in recovering liquidated damages. For instance, question has arisen whether contracting parties can contract out of S. 75 and substitute their own calculation of liquidated damages. Besides, queries are also raised as to whether the courts would give recognition to clauses which exclude the need to prove losses, or where the parties acknowledge that the losses suffered are difficult to quantify or that the amount stipulated in the LDC is a 'reasonable compensation' (adopting the phrase from S. 75) or is a genuine pre-estimate of the losses suffered.

The Federal Court in *Johor Coastal* was invited to determine whether S. 75 can be contracted out by the contracting parties. However, since there was no such clause in the contract in dispute, the Court held that it was not necessary to make a conclusion on this matter. However, the majority of the judges in this case seem to opine that S. 75 cannot be excluded.

The Court in *Johor Coastal* also did not discuss whether the courts would give any weight and if so, how much, in relation to the clauses which would assist the aggrieved party to satisfy the requirements in S. 75 to claim the full amount of the liquidated damages. In this case, the LDC provided that the liquidated damages amount to 'reasonable compensation'. Yet, the majority of the judges did not give any significant weight to it as they decided that since the aggrieved party could not prove its losses, it was not entitled to claim any liquidated damages.

In the event that the above contractual clauses could not assist the aggrieved party, he must be prepared to prove losses unless the situation falls within the exception in Selva Kumar where it is 'very difficult to assess the reasonable compensation' within the settled rules. The difficulty lies in what kind of evidence must be adduced. Put simply, is evidence documenting some losses sufficient or must the aggrieved party adduce evidence to show the exact losses suffered. Phang (1998) in his book states that:

The plaintiff is still under the duty to adduce evidence of her actual damage or loss. However, an inability to quantify such damage

will not thereby prejudice the plaintiff; indeed, in a situation where the plaintiff is truly unable to prove the actual quantum of damage or loss, the court will attempt its level best to determine what constitutes 'reasonable compensation' within S. 75 and may in fact, have recourse to the actual sum named in the contract as a (if not the) major factor

As such, the court in *Lam Soon (M) Bhd v Maxharta Sdn Bhd* advised that the aggrieved party should always try to prove loss. This would then show whether the loss is difficult to prove or otherwise. However, it is submitted that there is always a danger if the aggrieved party is unable to prove the amount of losses. In this situation, there is a fear that the courts would decide that since the possible losses are not substantial, the amount stated in the LDC is unreasonable. Due to this uncertainty, the courts might place emphasis on the adduction of evidence of legal injury as well as the actual amount of losses suffered. Particularly, in *Selva Kumar*, the court held that in situations where it is inherent that some losses would be caused and can be assessed within existing rules, the failure to prove loss is fatal to the claim on recovery of liquidated damages.

Besides, it is still unsettled as to the categories of situations where it is difficult to assess the quantum of damages. In *Selva Kumar*, the court gave an example of such situation where losses were caused by loss of an opportunity to attend an interview. It is difficult to assess losses suffered by the plaintiff as she might not be necessarily chosen from the interview. Other types of contract include contracts entered into to procure the construction of a building or any other types of provision of goods and services for the benefit of the public. For instance, if the government enters into a contract with a builder to construct a bridge to ease the travelling time of its people, it will be difficult to assess compensation if the builder delays in completing the construction of the bridge. In other situations, the position is not so clear-cut due to conflicting opinion of the courts. For instance, in *Johor Coastal*, the Federal Court was divided whether the losses suffered by the aggrieved party in this case were capable of assessment. The breach of contract in this case concerned the failure of the purchaser to complete the necessary payments for the purchase of two pieces of land. The dissenting judge in this case stated that the case of *Selva Kumar* can be distinguished as the sale and purchase contract in this case was more complicated as it also included the construction of buildings on these lands. The majority of the court in this case disagreed.

Another type of situation where it remains arguable whether there is a need to prove loss is in relation to losses suffered as a result of delay in delivery of vacant possession or completion of a construction project. In *Keen Builders Sdn Bhd v Utara Dua (Malaysia) Sdn Bhd*, it was held that in a delay of completing a construction project, losses are difficult to assess due to variable factors such as 'fluctuation of the ringgit, the parties' consensus of having mutually agreed upon a figure'. Thus, the aggrieved party was not required to prove loss. It can be contended that such factors are very common in relation to breach of contract arising from a delay in performance of a contract. As a consequence, it may be very easy to avoid the requirement to prove loss. The conundrum posed is whether such an outcome was envisaged by the Supreme Court in *Selva Kumar*.

There are also other cases where the application of S. 75 was not clarified which added to the confusion surrounding the recovery of liquidated damages in Malaysia. From *Selva Kumar*, it was made clear that as long as the losses are capable of assessment, the aggrieved party is still required to adduce evidence as to his losses. Otherwise, the court would not grant any damages to him. For instance, in *Cardigan Guards Sdn Bhd v Malaysian Government*, the court opined that a breach of contract to supply security guards as required by the contract would result in hardship in finding replacement guards. However, whether such situation falls within the category of situations where losses was incapable of assessment can only be determined in a full trial with the adduction of evidence.

However, there are some cases whereby the court readily allows recovery of liquidated damages without further explanation on the need of the party to prove loss. In *BerjayaTimes Square Sdn Bhd v Twingems Sdn Bhd*, one of the issue arose was whether the landlord of a shop in a shopping mall was entitled to recover liquidated damages from its tenant according to the following clause:

Clause 10(2): In the event that the Tenant unilaterally determines and/or terminates this tenancy agreement before the expiry of the term hereby created the tenant shall pay forthwith to the landlord as agreed liquidated damages the whole of the monthly rental and service charges for the duration of the unexpired and remaining term

The tenancy agreement in this case was for 3 year. After about four months, the tenant requested the landlord to mutually terminate the agreement as the tenant no longer able to sustain losses as a result of lack of sales

of the tea shop, the business ran by the tenant. This request was rejected by the landlord. The High Court allowed the landlord to claim the full amount stated under the LDC. It was not clearly provided in the judgment as to the kind of evidence adduced by the landlord as to his losses. Perhaps, in this situation, the loss suffered was obvious, i.e., loss of rentals for the remaining duration of the tenancy agreement. Nonetheless, the actual amount of losses could be lesser than the one stated in Clause 10(2) if the landlord could rent out the shop lot immediately or a few months after the termination of the tenancy agreement. This also goes to support that the amount claimed by the landlord might be unreasonable. Again the court in *Berjaya Times Square* did not address this issue.

Similarly, in *Chan Wey Siong v Pantas Wangsa Sdn Bhd*, the High Court allowed the full recovery of the amount stated in the LDC without any indication of the actual loss suffered by the aggrieved party. The contract concerned in this case was an agency agreement which was alleged to be wrongfully terminated by the principal. The High Court applied S. 75 and *Johor Coastal* in coming to its decision. With due respect, S. 75 and *Johor Coastal* requires an enquiry as to whether the losses suffered is capable of assessment. If so, the aggrieved party is required to prove its losses. But, none of these queries were discussed in the judgment.

In *Atlantic Plantation Sdn Bhd v Mature Land Sdn Bhd*, the defendant failed to provide vacant possession of about 50 acres from the total of 500 acres of land sold to the plaintiff which claimed that it suffered losses as a result of its inability to harvest palm oil on the 50 acres of land. The LDC in this case provided that the defendant shall pay the plaintiff interest at 10% per annum on the purchase price calculated on a daily basis till the date of delivery of vacant possession. The High Court stated that. There is no necessity to adduce further proof of loss for this head of claim as it is clear on the face of the SPA. The court went on to impose its own method of calculation of losses. The losses payable to the plaintiff is 10% based on the value of 50 acres and not 500 acres as stated in the LDC.

### **THE WAY FORWARD**

From the above discussion, one would realize that the immediate difficulty on the recovery of liquidated damages in Malaysia is due to the extent to which the courts insist on proof of actual losses. This has created confusion as there are conflicting cases on this matter. As such, it is necessary to determine the appropriate approach that should be taken in Malaysia in this area of law.

It is submitted that the basis underlying S. 75 is fairness. Particularly, the requirement of 'reasonable compensation' shows the Parliament commitment to protect the weaker contracting party from being manipulated by the stronger party in agreeing to an unjustified large sum of damages. But the conundrum posed is whether should such protection be afforded in situations where both the contracting parties have engaged in lengthy negotiation on the terms of the contract and are represented by legal advisors who have clearly advised them as to the effects and consequences of the terms of the contract. In such instances, failure to uphold the LDC may defeat the expectations of the parties or allow the party in breach to blow hot and cold on his promise under the LDC.

There is a general acceptance of the courts that they should be slow to interfere with contractual terms agreed by commercial parties who are well-represented by their legal advisers. For instance in England, the courts have begun to broaden the principles applicable to determine whether the amount in a LDC is recoverable. In *Azimut-Benetti SpA (Benetti Division) v Darrell Marcus Healy*, the plaintiff agreed to construct a luxurious yacht for a buyer but the latter failed to pay the installments in time. The plaintiff applied to court to enforce the LDC against the defendant (guarantor) which allowed it to retain 20% of the contract price (7.6 million) as liquidated damages in the event of late payment by the buyer. The High Court allowed the plaintiff's claim. In coming to this decision, the court is highly persuaded by the fact that the LDC is 'commercially justifiable' despite the fact that it did not represent a genuine pre-estimate of loss. The evidence in this case showed from the negotiation of the parties, the LDC was not intended to deter the buyer from breaching the contract but rather is to ensure that the parties are reasonably compensated in the event of breach of contract. As such, the seller was only allowed to retain the 20% of the purchase price. Any additional amount paid was returned to the buyer.

The High Court in *Azimut* followed Lord Woolf's advice in *Philips Hong Kong Ltd v AG of Hong Kong* that 'the court has to be careful not to set too stringent a standard and bear in mind that what the parties have agreed should normally be upheld.'

Besides, a comparison should also be made with the guidance issued by the Council of Europe entitled 'Resolution on Penalty Clauses' in 1971. This guidance provides a list of factors to be considered in determining whether the amount stated in an agreed damages clause is recoverable or should be reduced. The factors include comparison with pre-estimated damages, type of contract, legitimate interest of the parties, circumstances in which

the contract is concluded, social and economic position of the parties, whether it is a standard form contract and whether the breach was in good or bad faith.

In the United States, the Uniform Commercial Code as well as the Restatement (Second) of Contracts provide that liquidated damages are allowed if it is at 'an amount that is reasonable in the light of the anticipated or actual loss caused by the breach and the difficulties of proof of loss' (emphasis added). Some of the possible difficulties of proof of loss identified are the inability to assess loss due to the nature of losses claimed, the difficulty and expense of securing witnesses (Harwood, 1977).

After perusing the various approaches adopted in other countries, the remaining questions are whether the Malaysian courts should adopt the various approaches and whether they can fit into S. 75. It is contended that since S. 75 is intended to prevent any weaker party from agreeing to a huge amount of liability in the event of breach of contract, such possible victimization may not occur if both parties are of equal standing and receive proper legal advice before entering into the contract. It must be borne in mind that the LDC is introduced for a purpose that is to allow the parties to arrange the division of loss and liability among themselves to ensure prompt settlement of any dispute between them. To defeat the full application of a LDC is to take away the advantages of a LDC and create a dent on the principle of freedom of contract (Garcia, 2012).

In addition, the wordings of S. 75 do not preclude the courts from taking a wider approach in determining whether to give effect to a LDC. Thus, in determining whether the aggrieved party is required to prove losses, the difficulties of proof can be utilized instead of focusing on the ability to assess the losses suffered only. Furthermore, in a commercial contract, it is certainly possible for the courts to determine the circumstances

in which the contract is concluded. If both parties are fully aware of the consequences of the LDC, this shows that the parties have acknowledged that some losses would be caused by a breach of the contract and this can be used to support the argument that the amount stated in the LDC is reasonable.

## **CONCLUSION**

In summary, the major legal pitfall in relation to the recovery of liquidated damages is the uncertainty as to the situations in which the requirement to prove losses is precluded. Another difficulty is in relation to the principles or considerations applied by the courts in determining 'reasonable compensation'. As such, once there is a legal challenge on the amount of liquidated damages, there is no guarantee that the amount stated in the liquidated damages clauses is recoverable. The discussion in this article also shows that the courts in applying S. 75 can adopt a broader approach in determining whether a LDC should be given full effect. It is hoped that the Federal Court in Malaysia would have the opportunity soon to state their stand on whether Malaysia should such a broader approach and to give guidance to all lower courts on in this area of law.

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