Liquidated damages – The Bigger Picture

Faisal Attia
f.attia@tamimi.com

The employer is entitled to deduct a specified and pre-agreed amount of money from the contractor by way of compensation for failure to progress the works to meet set milestones or the date for completion of the works.

The position of liquidated damages under the UAE law may differ significantly from the position under other jurisdictions (particularly common law jurisdictions). As such, the enforceability of these clauses may bring less certainty for both developers and contractors operating in UAE.

The purpose of this article is to shed some light on liquidated damages under the UAE law and will seek to highlight the rationale behind the rules applicable to this type of damages.

I. Legal Characterisation

It should be noted, from the outset, that liquidated damages clauses are deemed to be ancillary contractual obligations, in the sense that they will not apply unless an obligation for payment of damages (i.e. the primary obligation) has been established in the first place. In other words, liquidated damages are not, per se, a cause of action for a claim for damages. Rather, they can only be invoked for establishing the amount of damages claimed .

For instance, there are two distinct obligations arising out of a liquidated damages clause (concerning delays) in a construction contract. Firstly, the contractor's obligation to complete the works within a specified time limit (i.e. the primary obligation). Secondly, the contractor's obligation to pay liquidated damages (i.e. the ancillary obligation), provided that the contractor is in breach of the primary obligation and the employer has sustained actual loss as a result of this breach.

Consequently, when the primary obligation elapses, the liquidated damages clause, being an ancillary obligation, elapses as well but not vice versa.

II. Unenforceability of Liquidated Damages

Liquidated damages can be rendered unenforceable outright in two cases, namely (i) the failure to establish any of the requirements for liquidated damages; or (ii) the termination of the primary obligation.

Tripartite test

Under the UAE law, in order for liquidated damages to be awarded, the following requirements must be satisfied (failing which, no liquidated damages would be awarded):

A) A breach committed by the party who agreed to pay the liquidated damages;

B) Actual damage sustained by the party who invokes the liquidated damages clause ; and

C) A causative link between the fault and the damage suffered.

The UAE high courts have confirmed, in several occasions, that this tripartite test must be satisfied. The Dubai Court of Cassation held that the inclusion of a liquidated damages clause into a contract does not supersede this tripartite test for awarding damages . The Federal Supreme Court has also concluded that the liquidated damages are subject to this tripartite test .

Termination of primary obligation

Liquidated damages agreements are ancillary contractual obligations and they will not be enforceable unless another (primary) obligation has been established. As a result, if the primary obligation is terminated, the liquidated damages clause shall be disregarded as well.

This rule has been consistently applied by the UAE high courts. For instance, the Dubai Court of Appeal ruled in favour of an employer who requested this court to (a) declare the construction contract in question be terminated; and (b) order the contractor to pay to the employer the liquidated damages as contemplated into this construction contract. However, the Dubai Court of Cassation reversed this judgment on the basis that the liquidated damages cannot possibly be awarded upon the termination of the construction contract. This is because, as per the court's findings, the liquidated damages are ancillary contractual obligations and therefore they shall be disregarded upon the termination of the construction contract, being the relevant primary obligation.

Accordingly, the contracting party who invokes a liquidated damages clause should not request the court to terminate the relevant contract (i.e. the primary obligation).

Upon the termination of the primary obligation, and assuming that the tripartite test is satisfied, the court would assess the damages in accordance with the general rules for damage assessment (i.e. actual loss sustained and loss of profits) not the pre-agreed amount of liquidated damages.

III. Adjustment of Liquidated Damages

Whilst Article 390(1) of the UAE Civil Code gives the contracting parties the right to agree on a fixed amount of damages in advance, Article 390(2) gives the court the ultimate right, upon the request of one of the parties, to increase or decrease the amount of these damages in order to reflect the actual loss suffered. The contracting parties cannot opt out of Article 390(2).

Article 390 of the UAE Civil Code reads:

"(1) The contracting parties may fix in advance the amount of damages either in the contract or in a subsequent agreement, subject to the provisions of the law.

(2) The judge may in all cases, upon the request of either of the parties, vary such agreement so as to make the damages equal to the loss, and any agreement to the contrary shall be void".

The practice of UAE courts shows that these courts exercised their discretion, as per Article 390(2), and reduced the amount of pre-agreed liquidated damages accordingly.

As for the increase of the amount of liquidated damages, there is no much case law support this. However, the Official Commentary on the Civil Code, which is issued by the UAE Ministry of Justice, expressly provides (concerning Article 390) that "If the damages are due and the same is equal to the loss sustained, then the liquidated damages agreement in question shall be upheld. However, if the due damages are not equal to the loss sustained, the judge shall have the right, upon the request of one of the parties, to increase or decrease the amount of these damages in order to reflect the loss. This is in line with the Shari'ah principles under which compensation shall be equal to actual loss suffered".

This suggests that the UAE courts remain entitled (at least in principle) to increase the amount of the liquidated damages.

IV. Burden of Proof

As indicated above, liquidated damages agreements can either be rendered unenforceable completely or be adjusted. A consequential question is whether there are any legal consequences arising out of a liquidated damages agreement.

A liquidated damages agreement should shift the burden of proof from the party who invokes this agreement to the other party. As such, the court should be bound by the liquidated damages agreement unless this other party proves that no damages were suffered. In other words, an assumption of damage shall be created in favour of the party who invokes a liquidated damages agreement. However, this assumption is refutable and the other party may prove otherwise.

Further, the court is still required to show the components of any liquidated damages it may award notwithstanding the shifting of burden of proof rule. This means that although the liquidated damage agreement shall shift the burden of proof, the court still has a duty to highlight the components of any damages awarded.

V. Conclusion

The ancillary nature of the liquidated damages clauses seems to be the main rationale for the most of the rules applicable to this type of damages. Such ancillary nature should therefore be kept in mind while considering liquidated damages clauses.

Footnotes:

1- Abdal-Razzak El-Sanhuri, “Commentary on the Civil Code”, Egyptian Bar, Vol. 2, 2007, P. 769.
2- This is because the primary obligation shall survive the unenforceability/invalidity of the liquidated damages clause.
3- Potential damages are excluded.
4- Petition no. 494/2003, the hearing of 24 April 2004.
5- Petition no. 344/19, the hearing of 23 January 1999.
6- Petition no. 402/2004, the hearing of 28 March 2005.
7- Petition no. 221/2007, the hearing of 17 December 2007.
8- Generally, components of damages are actual loss suffered and loss of profits.