Liquidated Damages in the DIFC Courts

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They involve parties agreeing, by means of a contract, that a pre-determined sum is payable in the event that one of the parties breaches a term of the contract.

The DIFC Courts may recognise liquidated damages provisions in agreements, regardless of whether they are applying DIFC law or another governing law to the dispute before them. The DIFC Courts will apply DIFC law to a matter unless the contracting parties have expressly agreed to submit their dispute to another governing law, which they are permitted to do pursuant to Dubai Law No. 12 of 2004 (as amended) (Judicial Authority at the Dubai International Financial Centre) and DIFC Law No. 10 of 2004 (Court Law). If a governing law other than DIFC law is chosen by the parties to a dispute, expert evidence as to that law must be adduced by the parties seeking to rely on it in DIFC Court proceedings. It should also be noted briefly that the DIFC Courts generally recognise contracting parties' express choice of jurisdiction, i.e. the courts which the parties selected to determine claims between them.

DIFC law comprises a significant body of legislation, regulations and cases, even though the DIFC is a relatively new jurisdiction (having only been established in 2004). Its laws include the DIFC Law of Contract (Law No. 6 of 2004) and the DIFC Law of Damages and Remedies (DIFC Law No. 7 of 2005). Article 21 of Law No. 7 of 2005 sets out the following provisions relating to agreed payments for non-performance:

- Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party is entitled to that sum irrespective of its actual loss.
- However, notwithstanding any agreement to the contrary the specified sum may be reduced to a reasonable amount where it is manifestly disproportionate to the loss envisaged as capable of resulting in relation to the loss resulting from the non-performance and to the other circumstances.

The test set out in Article 21(2) above is set out in a slightly different way in Article 122 of Law No. 6 of 2004, which provides that the liquidated damages sum specified in a contract can be reduced to a reasonable amount where it is "grossly excessive" rather than "manifestly disproportionate" to the harm resulting from a breach of contract. Article 122 reads as follows:

Where the contract provides that a party who does not perform is to pay a specified sum to the aggrieved party for such non-performance, the aggrieved party is entitled to that sum irrespective of its actual harm.

However, notwithstanding any agreement to the contrary, the specified sum may be reduced to a reasonable amount where it is grossly excessive in relation to the harm resulting from the non-performance and to the other circumstances.

To date there is no DIFC Court precedent for what might be considered "manifestly disproportionate" or "grossly excessive" in the context of a claim for the enforcement of a liquidated damages clause. However, the DIFC Courts have enforced a liquidated damages clause in a case where they held that the defendant had no answer to the claim for liquidated damages (CFI 004/2007 Arabtec Construction LLC v Ultra Fuji International LLC).

The DIFC law tests for the validity of liquidated damages clauses – "manifestly disproportionate" and "grossly excessive" – suggest a high threshold test similar to the "extravagant and unconscionable" test employed under English law to determine the enforceability of liquidated damages clauses. The English Courts, recognising the benefits of such clauses and the overall principle that parties are free to contract, generally uphold liquidated damages clauses in a commercial context, provided that they do not amount to a penalty.

The DIFC Courts have recognised that DIFC law is modelled on English common law principles, and that in construing the applicable codified provisions of DIFC law it is appropriate to "add flesh to the concise bones of these [DIFC] legislative provisions by looking to the manner in which the English Courts have given effect to similar principles. Whereas the ruling principles are those laid down in the DIFC codes, the manner of application can properly be informed by reference to English law not as a default system but as an aid to construction and application" (CFI 8/2007 Ithmar Capital v 8 Investments Inc. and 8 Investment Group FZE, per Justice Colman at paragraph 112).

Under English law, liquidated damages clauses may be considered a penalty, and therefore unenforceable, if:

- the overriding intention of the clause is to coerce a party into performing rather than compensating an innocent party in the event of a breach;
- it does not serve a legitimate commercial purpose and is therefore not commercially justifiable;
- the sum in question greatly exceeds the actual losses, to the extent that it could be considered to be "extravagant and unconscionable";
- there is a single sum payable for both serious and trivial breaches regardless of the nature of the resulting loss; and/or
- in the context of breaches of payment obligations, the sum goes beyond what could be considered to be compensatory.

In conclusion, based on the English law principle that liquidated damages clauses are generally enforceable, it is clear that in applying DIFC law, the DIFC Courts will also generally uphold liquidated damages clauses unless they constitute a penalty as defined by the criteria set out above.