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What's inside?

England's Court of Appeal allows appeal - case was not one of pure omissions

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In our previous article we reported on the decision of England's Technology and Construction Court in *Rushbond Plc v The JS Design Partnership LLP*. The Court held that the Defendant firm of architects was not liable for damage to the Claimant's property caused by a fire started by intruders, when one of its architects (Mr Jeffrey) left the door to the property open while inspecting it for a potential purchaser. The Court held that the failure to lock the door may have allowed the intruders to enter the building, but did not provide the means by which they could start the fire and was not causative of the fire. This was a case of pure omissions, the Court said, and the common law does not generally impose liability for negligence in relation to pure omissions, including losses arising from the criminal actions of third parties, unless the case falls within two exceptions, neither of which applied here. England's Court of Appeal has allowed Rushbond's appeal against that decision.

Was this a case of pure omissions?

To succeed in the appeal, it was only necessary for the Appellant, Rushbond, to show that its claim was arguably not one based on pure omissions, or if it was, that it arguably fell within one of the exceptions to that rule. The Court of Appeal held that it was arguable that the claim was not one based on pure omissions, for the three reasons below.

General Principles

The Court of Appeal held that as a matter of general principles, the claim was not one based on pure omissions. It said that arguably all of the necessary ingredients of a negligence action were in place here: duty, foreseeability, breach and causation. The Respondent was a visitor at the Appellant's property and was there with the Appellant's permission. It was fanciful, the Court of Appeal said, to suggest that whilst the sole occupant of the property entrusted with the keys, the Respondent owed no duty of care to the Appellant to take reasonable precautions as to security.

Respondent's involvement in relevant events

The Court of Appeal referred to the fact that "pure omissions" cases are ones where the defendant did nothing, or certainly nothing of any legal relevance to the claim. It said that the authorities make it clear that such situations are to be contrasted with those cases where the defendant is involved in a particular activity, and it was negligent in carrying out that activity that gave rise to the claim.

The Court of Appeal said that in the present case, the Respondent was involved directly in the activity which allowed the intruder to enter the property i.e. Mr Jeffrey had deactivated the alarm and left the door unlocked. On that basis, Mr Jeffrey had not just provided an opportunity for the intruder to get in, but arguably was in breach of duty because he positively made things worse by rendering a secure building insecure, at least for the duration of his visit. By doing that, Mr Jeffrey may or may not have been negligent-that was a question for another day, the Court said-but it could not unequivocally be said that he did not owe a duty of care because such duty would be based on "pure omissions".

The Court said that negligence claims like this one are often focused on an omission, in the sense of something the defendant has failed to do. In this case, it was Mr Jeffrey's decision not to lock the door once he and his colleagues were inside. However, that, the Court said, was part of a series of acts and omissions arising out of his visit: deactivating the alarm, not locking the door, leaving the area of the door unguarded etc.

Moreover, the Court said, this sort of semantic bickering – can it be presented as a positive act or omission? - is not what the rule in relation to "pure omissions" is all about. All negligence claims involve acts (things done that should not have been done) and/or omissions (things which ought to have been done but were not done). It does not mean that a case like this one, where the failure to do something (locking the door) was part of an activity undertaken by the tortfeaser that gave rise to loss, can be said to be a claim based on "pure omissions".

The Court of Appeal considered that failure to lock or otherwise guard the door after entering the property was a central part of Mr Jeffrey's activity that allowed the intruder into the property. It was arguably not a pure omission, the Court said, in the sense used in the case authorities and was instead an actionable wrong and the judge below had erred in concluding otherwise.

Keeping property secure line of authorities

The Court of Appeal held that the case fell within a recognised line of authorities concerning the duty to take reasonable steps to keep property secure and the judge below had been wrong to find that the case did not fall into that recognised category of decided cases where a relevant duty had been found.

The Court of Appeal found that the case was indistinguishable from *Stansbie v Troman* [1948] 2 KB 48, where a decorator did not lock the door and, as was foreseeable, a third party got into the house and stole property. The householder claimed the value of the stolen property from the decorator and the claim succeeded and was upheld on appeal.

The judge below had taken a different view because she said *Stansbie and Troman* was based on a contract between the decorator and householder However, the Court of Appeal said that was an incorrect reading and that it made no difference that there was a contract between the decorator and householder. What mattered, the Court said, was that the decorator was in the house as a licensee. So too, in the present case, was Mr Jeffrey.

Court of Appeal decision

Accordingly, the Court of Appeal allowed the appeal, holding that it was arguable that this was not a case of "pure omissions" and that, in any event, it was a case that fit within a line of authorities which potentially rendered the Respondent liable for the consequences of their failure to take reasonable steps to ensure that the Appellant's property was properly protected during Mr Jeffrey's visit.

Comments

In this case, the Defendant applied to strike out the Plaintiff's claim and/or for summary judgment. For such applications, the burden on the plaintiff is only to show an arguable case against the defendant i.e. that it is at least arguable that it was not a case of "pure omissions". Whilst the defendant may still maintain the defence of "pure omissions" at the trial, it would be an uphill battle, given the decision of the Court of Appeal.

A reminder that quantification of loss must be supported by detailed expert evidence

Stanley Lo

In the recent case of *Hip Hing Construction Company Ltd v Hong Kong Airlines Ltd,* HCCT 72/2021, the Court granted the Plaintiff summary judgment for over HK$200 million, being the sum outstanding under a construction contract. The Defendant did not dispute that the sum was owing, but sought to set off over HK$200million, for the Plaintiff's alleged defective works. Although the existence of defects was not in dispute, save for the sum of HK$21 million, the Court granted summary judgment to the Plaintiff, as the Court found that the Defendant had not properly particularised some items of loss or provided support for them and it found the costs of some of the proposed remedial works manifestly excessive and only supported by an oral estimate.

Background

The Plaintiff was the main contractor engaged by the Defendant for the construction of the Hong Kong Airlines Aviation Training Centre (Training Centre) at Chek Lap Kok. The Plaintiff claimed against the Defendant for the outstanding contract sum of HK$215,980,000 plus interest. There was no dispute that the sum was due and owing to the Plaintiff, but the Defendant counterclaimed and sought to set off losses that it said it had incurred as a result of the Plaintiff's defective work. The Defendant claimed that there were various defects in the building works, the most serious of which concerned water leakage at the basement, which comprised (i) basement screen walls constructed by the Plaintiff and (ii) footings and raft slabs constructed by Kim Hung, the specialist contractor for foundation works.

According to the Defendant, the Plaintiff had agreed to "take over" the work done by Kim Hung under a "Takeover Agreement", by virtue of which, the Plaintiff was to be held responsible, not only for its own works, but also the works of Kim Hung.

The Defendant's set off and counterclaim

The Defendant instructed two external consultants to propose remedial solutions for the water leakage problem and based on an "oral costs estimate" provided by a Mr Ching, the Defendant claimed that the remedial costs totalled approximately HK$212 million. Mr Ching had not provided a written estimate with a costs breakdown.

The Defendant claimed that during the remedial works, it would not be able to use the Training Centre to train its pilots and staff, and would have to send its pilots and flight crew overseas to undergo regular training, at a total estimated cost of HK$76.43 million. There was no evidence that such training costs had been incurred.

Apart from the water leakage problem at the basement, there were (and remained) various other defects in the Plaintiff's building works at the Training Centre. According to a preliminary report prepared by the Defendant's in-house engineer (Mr Tsoi), the costs of those proposed remedial works were estimated at HK$30.07 million. All but one of the items, were lump-sum estimates without adequate particulars or breakdowns.

Could the Defendant substantiate the defects?

The Court said that for present purposes, it would concentrate on the water leakage in the basement, as the Defendant's evidence concerning other defects was quite unsatisfactory and for some of those other defects some rectification works had already been carried out. The Court noted that the burden was on the Defendant to identify what defects attributable to the Plaintiff remained outstanding and the costs (with sufficient particularities) of the rectification works. The Court was not satisfied that the burden had been discharged in respect of those other defects, apart from two of them (2 Defects). It was for the Defendant, the Court said, to point out specifically what the outstanding defects and relevant costs of rectification were and it was not for the court to look high and low to see which of the many items of alleged defects had or had not been dealt with over the years.

The Court was satisfied that the Defendant had made out an arguable set-off or counterclaim in respect of the loss that arose from the leakage. That set-off or counterclaim arose out of the same project as the Plaintiff's claim and it would therefore be manifestly unjust to allow one to be enforced without regard to the other.

The Court did not find any merit in the Defendant's contention on the Takeover Agreement, as it was not supported by any contemporaneous document. The Court said that is was self-evident that is was a highly onerous and risky obligation for the Plaintiff to take on and the Defendant's suggestion that in return the Plaintiff was able to gain control of the site and start its work earlier was quite unconvincing.

Quantum of the Defendant's Losses

The Defendant claimed three items of loss:

- Item 1: Costs of proposed remedial works for the leakage: HK$212 million;
- Item 2: Training costs for sending the Defendant's pilots and staff overseas to undertake training: HK$40 million per year
- Item 3: Costs of proposed remedial works for the 2 Defects.

In respect of each item of loss the Court held:

Item 1 -The Defendant had failed to condescend to details as to how the figure of HK$212 million was calculated. It was derived from an oral preliminary estimate provided by Mr Ching. The Plaintiff had obtained a costs estimate report from an experienced quantity surveyor who assessed, with a breakdown, that the proposed remedial works would cost only HK$21 million. In light of such evidence, Mr Ching's estimate appeared manifestly excessive.

Item 2 – The Defendant claimed that the mechanical and electrical plant supporting the flight simulator equipment in the Training Centre would have to be shut down when remedial works were being carried out to address the leakage and the Defendant would therefore have to incur over HK$40 million per year to send its pilots and staff for training overseas. The Defendant's proposed remedial works were limited to the ground floor and basement of the building. The mechanical and electrical plants were controlled floor by floor and there was no satisfactory evidence to explain why the Defendant would not be able to use the other floors of the Training Centre for training. The Defendant's case that the whole Training Centre would be rendered unusable was little more than a bare assertion. It must be borne in mind that the Defendant was under a duty to mitigate its loss. Assuming that the mechanical and electrical plant had to be shut down, common sense dictated that mitigating measures could be put in place to, e.g. minimise the down time and/or re-arrange the training hours. Further, why would the training of other staff be affected assuming that the flight simulator could be used? In any case, the breakdown for this claim of HK$40 million of training costs was not explained. There was no information on where the staff would be sent, the number of staff currently retained by the Defendant and how many of them would have to be sent for training at any given time. This very substantial loss had not been made out on the evidence. This was not a bona fide or believable claim.

Item 3 - There was no proper evidence for the requisite rectification works for the 2 Defects and the costs of them. The Defendant's remedial costs estimates were all lump-sum items with no particulars or breakdowns. It was not a matter of guesswork for the court based on such unparticularised estimates. In the absence of the requisite evidence, the Defendant should resort to its right under the Plaintiff's guarantee.

Court's Decision

Accordingly, the Court granted the Plaintiff summary judgment for the amount claimed, save for HK$21 million for those defective works of the Plaintiff that the Defendant had been able to substantiate.

Comments

In order for a defendant to succeed in defending a summary judgment application, they have to show an arguable defence to the plaintiff's claim. It is not a high burden for the defendant to discharge, especially in construction projects, where the usual defence is set-off for delay and defective work of the contractor. In many cases, the court may not have the opportunity to go through all the details to determine the merits of the defence. However, in this case, the defendant succeeded in raising the defence of set-off but the evidence on quantum of loss and damage was so unsatisfactory that the Court saw fit to dismiss it, even in a summary judgment application. The lesson to be learnt by employers is that the quantification of loss must be supported by detailed expert evidence.

Abandoned contracts – how should damages be assessed?

Leo Wong

It is not uncommon that renovation contractors abandon the works contracted for, despite having received partial payments and the employer needs to engage a replacement contractor to finish the outstanding works. The usual question is not whether the original contractor is liable, but how the quantum of damages ought to be assessed.

In *New Era Group (China) Limited v Studio M Interiors HK* Limited [2021] HKCFI 3711, the Court of First Instance considered how damages should be assessed when a fitting out contractor abandoned the works and the owner engaged a new contractor to complete only some of the outstanding works and to carry out some additional works originally not required. Whilst the Court was of the view that the normal measure of damages for breach of contract is the cost to the owner of completing the original contract in a reasonable manner less the original contract sum, the Court found it inappropriate to assess damages based on the cost of completing the works under the original contract because completion of the works under the original contract was no longer meant to be achieved due to the owner's substantial change in the scope of works. Eventually, the Court assessed damages based on expert evidence produced by the owner on (i) the difference between the partial payments made to the original contractor and the value of the works carried out by the original contractor and (ii) the market rent of the property for a reasonable period of the owner's loss of use and enjoyment of the property.

In rejecting the period claimed by the owner and assessing the "reasonable period", the Court held that the owner failed to provide a reasonable explanation as to why it took the owner over 3 months to engage the new contractor after accepting the original contractor's repudiation and that a reasonable time for the owner to engage a new contractor was 1 month and, having taken into account the proportion of additional works to the new contract, made an assessment of the time reasonably required for the new contractor to complete the outstanding works under the original contract (i.e. exclusive of the time impact of the additional works, which was not caused by the original contractor).

Takeaway

If the scope of works under the new contract only covers the outstanding works under the original contract, the Court can put the innocent party back into the position it would have been in by comparing (a) the value of the outstanding works that should have been done under the original contract and (b) the costs incurred under the new contract to complete such outstanding works, and taking into account loss and damage that arose from the delay in completing the works.

However, when the scope of works under the new contract has substantially changed and the impact of the changes on time and costs are not readily distinguishable, this approach may no longer be appropriate. In this situation, the Court can only do its best on the available evidence to assess the loss and damage arising from the breach and isolate the impact on time and costs not arising from the breach.

Appealing arbitral awards on questions of law

Justin Yuen

KH Foundations Ltd v Sze Fung Engineering Ltd, CAMP 222/2020, concerned a dispute between a contractor and subcontractor arising from five subcontracts regarding two residential development projects. The dispute was referred to arbitration and the sole arbitrator issued an interim award on liability in favour of Sze Fung Engineering Ltd (SF), with quantum to be assessed at a later stage. KH Foundations Ltd (KH), for whom Deacons acted, applied to the Court of First Instance (CFI) for leave to appeal the award on questions of law. That application was refused (Refusal Decision). KH's application to the Court of Appeal for leave to appeal the Refusal Decision was dismissed. The judgment usefully sets out the requirements for appealing an arbitral award on questions of law and also the requirements for obtaining leave to appeal a decision granting or refusing leave to appeal an arbitral award.

When will the Court interfere with an arbitral award?

The Court of Appeal noted that a prominent theme of the Arbitration Ordinance (Cap 609) (Ordinance), is that the court's interference with arbitral awards is strictly circumscribed. There is no general right of appeal to the court from arbitral awards, but a limited regime for appeals on questions of law arising out of arbitral awards, is preserved in Schedule 2 to the Ordinance (Schedule 2). Schedule 2 may apply by the parties' choice or automatically in certain specified cases. It applied in this case.

Section 5 of Schedule 2 provides that, subject to section 6, a party to arbitral proceedings may appeal to the CFI on a question of law arising out of an award. The fundamental requirement, therefore is that the question put forward must be a question of law, not of fact.

How to distinguish a question of law from a question of fact

The Court of Appeal referred to the fact that some questions are easy to classify: the correct scope and content of a specific legal rule is obviously a question of law and traditionally the interpretation of contracts has been regarded as

a question of law. The Court of Appeal said that in less straightforward cases, dividing an arbitrator's process of reasoning into three stages, may be of assistance:

- Stage 1: The arbitrator ascertains the facts and makes findings on any facts which are in dispute.
- Stage 2: The arbitrator ascertains the law, which involves not only identification of all material rules of statute and common law, but also identification and interpretation of the relevant parts of the contract, and identification of those facts which must be taken into account when the decision is reached.
- Stage 3: In the light of the facts and the law so ascertained, the arbitrator reaches his decision.
- In some cases, stage 3 will be purely mechanical. Once the law is correctly ascertained, the decision follows inevitably from the application of it to the facts found. In other instances, however, the third stage involves an element of judgment on the arbitrator's part.
- Stage 2 is the proper subject matter of an appeal. In some cases, an error of law can be demonstrated by studying the way in which the arbitrator stated the law in his reasons. It is, however, also possible to infer an error of law in those cases where a correct application of the law to the facts found would lead inevitably to one answer, whereas the arbitrator has arrived at another.

The Court of Appeal said that the above suggested that, whilst generally only stage 2 of the process is the proper subject of an appeal on law, a question of law may arise in the third stage, if the decision is such as to be necessarily inconsistent with a correct understanding or application of the law.

Leave to appeal an arbitral award on a questions of law - the requirements

The Court of Appeal referred to the requirements for obtaining leave to appeal an arbitral award on a question of law:

- The application for leave to appeal must identify the question of law (section 6(2)(a), Schedule 2 of the Ordinance). The failure to identify a clear, crisp and correct question of law may result in the application being rejected on that ground alone.
- Leave to appeal is to be granted only if the court is satisfied of three conditions:
    - The decision of the question will substantially affect the rights of one or more of the parties (section 6(4)(a), Schedule 2 of the Ordinance). The question must be a point of practical importance i.e. not an academic or minor point.
    - The question is one which the arbitral tribunal was asked to decide. This will exclude any appeal on a new point of law which was not before the arbitral tribunal. It also means that not all errors of law that an applicant alleges to have been made by the arbitrator necessarily give rise to admissible questions of law for an appeal to the court. Simply posing the question whether the arbitrator may in law properly take a certain course does not mean it is therefore a question of law arising out of the award which the arbitrator was asked to determine.
    - On the basis of the findings of fact in the award, the arbitral tribunal's decision on the question of law was obviously wrong. This is a very high hurdle. Alternatively, on the basis of the findings of fact in the award, the question is one of general importance and the decision of the arbitral tribunal is at least open to serious doubt. "Open to serious doubt" represents a lower threshold than "a strong *prima facie* case".

Appealing a decision to grant or refuse leave to appeal an arbitral award

Once the CFI has made a decision to grant or refuse leave to appeal on the question of law arising out of the award, an appeal may lie from that decision but only with leave of the CFI or the Court of Appeal (section 6(5), Schedule 2 of the Ordinance). Such leave to appeal will not be granted unless (a) the appeal has a reasonable prospect of success, or (b) there is some other reason in the interests of justice why the appeal should be heard. However, a reasonable prospect of success is not enough, as by virtue of section 6(6) of Schedule 2, leave to appeal against such decision must not be granted unless *"(a) the question is one of general importance; or (b) the question is one which, for some other special reason, should be considered by the Court*".

The Court of Appeal held in *Maeda Kensetsu v Kogyo Kabushi Kaisha v Bauer Hong Kong Ltd* that where the CFI has granted leave to appeal from an award on the basis that the arbitral decision is at least open to serious doubt, since the assessment of that criterion can be quite subjective and different judges can reasonably come to different views,

the Court of Appeal should not intervene unless it can readily be demonstrated that the judge was “plainly wrong” in coming to that conclusion.

Court’s decision

The Court of Appeal dismissed the application as it found that there was neither general importance nor special reasons in the questions raised by KH. Accordingly, by virtue of section 6(6), Schedule 2 of the Ordinance, leave to appeal from the Refusal Decision simply could not be given.

Comments

Whilst the Ordinance allows parties to adopt Schedule 2 so that a party may appeal an arbitral award on a question of law, this case demonstrates the narrow circumstances and high hurdle to appeal an arbitral award on a question of law under section 5, Schedule 2 of the Ordinance, and to appeal a decision granting or refusing leave to appeal under section 6, Schedule 2 of the Ordinance. In many cases, the formulation of a question of law is not straight forward, especially when the question is a mixed question of fact and law.

Hong Kong construction industry personnel boost

Joseph Chung

The Hong Kong Government recently announced plans to allocate HK$1 billion for the training and recruitment of construction industry workers. The aim is to increase the number of training places to meet manpower needs of the booming infrastructure projects planned for Hong Kong in the coming years (including the Northern Metropolis and Lantau Tomorrow Vision projects). Details of the scheme were cited on the official blog post of Michael Wong, Secretary for Development as follows:

- The Government has been actively investing resources in infrastructure projects, including land construction, public housing, medical care, flood control, transportation construction, etc., to improve the living environment of citizens and promote economic growth. Together with the private market, the overall construction volume of the construction industry is expected to increase to the level of HK$300 billion per year.

- With more projects being carried out, the construction industry has had a strong demand for manpower, especially skilled workers. To this end, the Government proposes to allocate HK$1 billion to support the Construction Industry Council to further strengthen manpower training in the construction industry, train more new blood to join the construction industry and improve the technical level of current employees.

- The proposed measures are mainly divided into three areas:

    - First, the Government will increase the number of places and allowances for the Council to train job-transferees to become semi-skilled workers for the types of jobs that will have a high demand for manpower in the future, so as to attract more new recruits.

    - Second, increase the number of places and subsidies for the Council's "Professional Training Scheme" and "Skill Upgrading Courses" to help semi-skilled workers, who are currently employed and who have recently completed training, to upgrade their skills to the level of skilled workers. The promotion ladder is aimed at better attracting and retaining talent.

    - Third, assist the Council to strengthen the promotion of professional skills and development opportunities in the industry, and attract more newcomers to the construction industry, especially young people.

It is anticipated that the above measures could boost the number of semi-skilled site personnel by 20,000 and the number of skilled site personnel by 6,800.

Enforcement of liquidated damages clauses in Hong Kong after Cavendish

KK Cheung Leo Wong

Loss and damage arising from delay in construction works are notoriously difficult to quantify, even with the assistance of quantum experts. To overcome this, parties usually specify in construction contracts liquidated damages (LD) for loss and damage arising from delayed completion of the project, so that the parties can work out the LD by comparing the actual completion date and the contractual completion date (as extended) and multiplying that period with the agreed LD rate, without having to consider what actual loss and damage the employer has suffered due to the delay and adduce factual and expert evidence in support, the outcome of which can be very uncertain. However, if an LD clause is regarded as a penalty clause, Hong Kong Courts will not enforce it and in such scenario only general damages can be claimed (subject to proof). It is therefore important for construction practitioners to know when an LD clause would be enforced and when it probably would not, in particular when formulating or accepting or challenging an LD clause. This article discusses the approaches taken by Hong Kong Courts after the landmark ruling of the UK Supreme Court in ***Cavendish Square Holding BV v Makdessi*** **[2015] UKSC 67**, which was discussed in our previous article.

LD clauses generally enforceable

Construction practitioners should bear in mind that it is not easy to challenge LD clauses. Hong Kong Courts are generally reluctant to interfere with the parties' freedom of contract, especially when the contracting parties are business people of comparable bargaining power with proper advice.

- *"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. Any other approach will lead to undesirable uncertainty especially in commercial contracts*" (***Philips Hong Kong Ltd v A-G of Hong Kong [1993] 1 HKLR 269, HK Privy Council)***

- *"The threshold for the court's intervention is necessarily high. Where business people are dealing with each other at arm's length, their freedom to contract as they please is something the courts respect and protect." (**Polyset Ltd v Panhandat Ltd (2002) 3 HKLRD 319, HK Court of Final Appeal)***

- *"In a negotiated contract between properly advised parties of comparable bargaining power, the strong initial presumption must be that the parties themselves are the best judges of what is legitimate in a provision dealing with the consequences of breach" (**Cavendish Square Holding BV v Makdessi* **[2015] UKSC 67*, followed in Law Ting Pong Secondary School v Chen Wai Wah [2021] 3 HKLRD 185, Court of Appeal)***

Therefore, if a contractor thinks that the LD amount stipulated in the tender document is extravagant, it should either negotiate with the employer for a downward adjustment or just refuse to submit the tender. By submitting the tender, the contractor would be deemed to have agreed to the LD amount to be imposed and be bound by the LD clause upon the employer's acceptance of the tender. In this scenario, the contractor should expect that the Court would generally uphold the LD clause and the contractor would be ordered to keep its side of the bargain.

When LD clauses would not be enforced

While LD clauses are generally enforceable, the Hong Kong Courts may intervene when they find an LD clause penal. As regards what makes an LD clause "penal", different approaches have been taken by the Hong Kong Courts:-

(1) It will be held to be a penalty if the LD amount is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.

(2) It will be held to be a penalty if the breach consists only in not paying a sum of money and the LD amount is a greater sum than the sum which ought to have been paid.

(3) It will be a rebuttable presumption that it is a penalty if a single lump sum is made payable by way of compensation on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage.

(4) It is no obstacle to the LD amount being a genuine pre-estimate of damage that the consequences of the breach are such as to make precise pre-estimation almost an impossibility; on the contrary, that is just the situation when it is probable that pre-estimated damage was the true bargain between the parties.

(***Dunlop Pneumatic Tyre Company Limited v New Garage and Motor Company Limited [1915] A.C. 79, UK House of Lords***).

- "*As long as the sum payable in the event of non-compliance with the contract is not extravagant, having regard to the range of losses that it could reasonably be anticipated it would have to cover at the time the contract was made, it can still be a genuine pre-estimate of the loss that would be suffered and so a perfectly valid liquidated damage provision"* (***Philips Hong Kong Ltd v A-G of Hong Kong [1993] 1 HKLR 269, HK Privy Council)***

- *"…[the agreement] must not impose upon the breaker of a primary obligation a general secondary obligation to pay to the other party a sum of money that is manifestly intended to be in excess of the amount which would fully compensate the other party for the loss sustained by him in consequence of the breach of the primary obligation.*" (***Photo Production Ltd v Securicor Transport Ltd [1980] AC 827 at p.850F, approved in Polyset Ltd v Panhandat Ltd (2002) 3 HKLRD 319, HK Court of Final Appeal)***

All of these principles seem to point to one thing – the Hong Kong Courts would not enforce an LD clause if the LD amount is manifestly intended to exceed the "greatest loss" that could conceivably be proved to have followed from the breach at the time the contract was made and the "full compensation" for such loss. However, that position appears to have evolved in recent years:-

- "*A provision was penal if it was a secondary obligation which imposed 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…therefore, the fact that a provision did not provide for a pre-estimate of loss, or that it was deterrent, did not necessarily mean that it was penal, since the legitimate interest of the innocent party might extend well beyond the recovery of compensation for his loss...deterrence is not penal if there is a legitimate interest in influencing the conduct of the contracting party which is not satisfied by the mere right to recover damages for breach of contract…the dichotomy between the compensatory and the penal is not exclusive. There may be interests beyond the compensatory which justify the imposition on a party in breach of an additional financial burden…"(****Cavendish Square Holding BV v Makdessi*** **[2015] UKSC 67***)*

- *"The true test was held to be whether the clause is out of all proportion to the innocent party's legitimate interest in enforcing the contract…an innocent party could have a legitimate interest in the performance of the contract or some appropriate alternative to performance that goes beyond compensation...In applying the test, the court should first identify the legitimate interest of the innocent party that is being protected by the clause, and then assess whether the clause is out of all proportion to the legitimate interest by considering the circumstances in which the contract was made." (****Law Ting Pong Secondary School v Chen Wai Wah [2021] 3 HKLRD 185, HK Court of Appeal, applying Cavendish Square Holding BV v Makdessi*** **[2015] UKSC 67***)*

- *"The modern inquiry is no longer subject to the distinction between a penalty and genuine pre-estimate of loss. The court should first identify the legitimate interest of the innocent party that is being protected by the clause, and then assess whether the clause is out of all proportion to the legitimate interest by considering the circumstances in which the contract was made…On the question of penalty interest, in judging what is extravagant, exorbitant or unconscionable, the extent to which the parties were negotiating at arm's length on the basis of legal advice and had every opportunity to appreciate what they were agreeing must at least be a relevant factor: Bank of China (Hong Kong) Ltd v Eddy Technology Co Ltd [2019] 2 HKLRD 493 , §§3 & 8, applying Cavendish, §§152 & 35…Whether the interest rates were extravagant, unconscionable or incommensurate with any legitimate interest is for the party in breach to show: Cavendish, at §143." (****China Great Wall AMC (International) Holdings Co Ltd v Royal Bond Investment Ltd [2021] HKCFI 2882, following Law Ting Pong Secondary School v Chen Wai Wah [2021] 3 HKLRD 185***)*

From the above-mentioned judgments of the Hong Kong Courts, it can be seen that in order to decide whether an LD clause is penal, the emphasis is now placed on considering the relationship between the legitimate interest of the innocent party and the LD amount.

It is important to note that Cavendish did not overrule Dunlop. Rather, the UK Supreme Court remarked that:

(a) the unsatisfactory distinctions between "a penalty" and "a genuine pre-estimate of loss" and between "a genuine pre-estimate of loss" and "a deterrent" originate from an *over-literal reading* of the 4 tests in Dunlop and a tendency to treat them as almost immutable rules of general application which exhaust the field when they are not; and

(b) the 4 tests set out in Dunlop above have proved perfectly adequate to deal with the great majority of cases decided in England since Dunlop which concerned more or less standard damages clauses in consumer contracts and would usually be perfectly adequate to determine the validity of LD clauses in cases involving straightforward damages clauses (where the innocent party's legitimate interest will rarely extend beyond compensation for the breach).

It was in such context that the UK Supreme Court introduced the broader test in Cavendish. As explained by the Hong Kong Court of Appeal *in Law Ting Pong* (applying *Cavendish*), "*notions of whether the clause has a deterrent purpose or whether it is a genuine pre-estimate of loss would be subsumed by the broader enquiry into the legitimacy of the interest that supports the provision*".

Before challenging an LD clause, construction practitioners ought to first identify the legitimate interest to be protected by the LD clause and then, based on evidence available, assess whether the LDs are out of all proportion to the legitimate interest, in particular when the LDs are meant to go beyond pecuniary compensation for loss and damage directly flowing from the breach in question. In an ordinary construction contract, the legitimate interest of the employer is to complete the project on time and the loss which he may suffer is usually additional finance cost and/or loss of use which should not be difficult to assess. However, this exercise may not be straightforward in other cases such as non-commercial projects with elaborate provisions for calculation of LD and phased completion.

Whilst the Court of Final Appeal of Hong Kong has yet to have the opportunity to consider this "breakthrough" in *Cavendish* and it remains to be seen whether it would continue to focus on "genuine pre-estimate of the probable damage" or move on to the test of legitimate interest as adopted by the Court of Appeal, it is foreseeable in the future that more and more cases of the Court of Appeal and the Courts below will adopt the line of authorities following *Cavendish*.

Development Bureau to grant extensions of time to Government Works Contracts

Joseph Chung

On 14 March 2022, the Development Bureau of the HKSAR Government announced that it would grant extensions of time to Government works contracts and the building covenant (BC) period under land leases of private development projects, having regard to the impact on the development and construction sectors caused by the fifth wave of the COVID-19 epidemic.

The Development Bureau announced that:-

(i) for all Government works contracts in progress, the Government will flexibly handle requests from contractors for extensions of time due to the impact of this wave of the epidemic, for up to a maximum of six months; and
(ii) for all leases with unfulfilled BC as at today, the original expiry of the BC period may be extended at nil premium by up to six months.

A Development Bureau spokesman said that they would also look to contractors and lessees granted an extension to handle the deadlines in their contracts with other contractual parties in a reasonable manner, such that other stakeholders in the production chain could also benefit from the extension by the Government.

In respect of development projects not subject to the restriction of BC period under the land lease (such as redevelopment projects which do not require lease modification), the Development Bureau appealed to the industry to handle the relevant contractual time limits by exercising flexibility in a sympathetic spirit during this difficult time.

It should be noted that the Development Bureau's announcement is only confined to entitlement of extensions of time. There is no mentioning of entitlement to additional payment.

Want to know more?

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