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When is a trust created over retention monies?

KK Cheung

Hip Hing Construction Company Ltd v Hong Kong Airlines Limited [2024] HKCFI 370, concerned clause 32.5 of the General Conditions of the Standard Form of Building Contract (2005 Private Edition) (GCC 32.5) which relates to retention money. It provides that the retention shall be held upon trust by the Employer for the Contractor and any Nominated Sub-Contractor or Nominated Supplier, subject to the rights of the Employer to have recourse to it for payment of any amount which he is entitled to under the Contract or at law or to deduct from it any sum owed to him by the Contractor. The Plaintiff (HH) sought a declaration from the court that the Defendant (HKA) held \$56,321,000 as retention money on trust for HH, pursuant to GCC 32.5, which was incorporated into the contract between HH as main contractor and HKA as employer (Contract). The court did not grant the declaration because it found that the trust failed for lack of certainty of subject matter, as the retention monies were not kept in a segregated account that could be identified.

Issue in dispute

The \$56,321,000 was the retention money withheld by HKA under the Contract and as certified under an Interim Payment Certificate issued by the Architect (Retention Monies). The Retention Monies had never, been paid into any separate bank account of HKA, nor segregated from the rest of HKA's receipts and funds held.

HKA had defaulted in payment of sums due for work carried out by HH under the Contract, under which the remaining balance of the Contract sum, including the Retention Monies, were to be paid within 90 days from issuance of the occupation permit. HH had commenced a High Court action and obtained summary judgment for HKA's payment of \$192 million, with leave granted to HKA to defend the balance of HH's claim for \$21 million. A winding-up petition was subsequently presented against HKA, and a scheme of arrangement (Scheme) and restructuring plan (Plan) were sanctioned by the court for HKA.

The issues before the court focused on whether there was a trust validly created over the Retention Monies held by HKA, and whether and to what extent, segregation of the funds was necessary for the creation of a trust. If the Retention Monies were trust assets belonging to HH, HH could take the money for itself,

bypass the equal distribution under the Scheme and not share in the general pool of HKA's assets with other creditors.

Applicable legal principles

For the creation of an express trust, there must be certainty of intention, certainty of subject matter and certainty of object. According to HKA, there was no identifiable trust property, in the absence of segregation or setting aside by HKA of any funds for the purpose of GCC 32.5 or the retention referred to under it and that the trust must fail for lack of certainty of subject matter. The question before the court therefore, was whether there was certainty of subject matter, and whether the property said to be subject to the alleged trust could be identified.

Having considered the two lines of conflicting case authorities, on the issue of whether segregation or appropriation is a necessary requirement for the existence of a valid trust, without which there can be no certainty of the subject matter, the court concluded that each case must be decided on its particular facts, taking into account the nature of the asset which is claimed to be the subject matter of the trust, and whether and how it can be identified with certainty. Segregation, it said, was one, but not the only, relevant factor.

The court said that what could be gathered from the case authorities in which certainty of subject matter was upheld by the court was that there had been clear identification of the property, which was not mixed with property of the alleged trustee and there was no problem in identifying the mass of what was held on trust and there were means of identifying and distinguishing the subject matter of the trust. For example in one case, the money was put into a designated "customer trust account" and in another into designated client accounts. In another, "the proportionate share of the undivided bulk" to which each account holder was entitled could be identified with certainty.

The court said that it is clear that an intention to create a trust, and the existence of a certain and identifiable subject matter of the trust, are both important and whilst segregation is normally an indicator of a trust, the mingling of funds is not fatal, and the court should look at all the circumstances as there may be other indicators of the trust.

Was there a valid trust?

The of GCC 32.5 makes clear provision for a trust, the court said. The clause in the Contract expressly provided that the Retention Monies "*shall be held upon trust*" by HKA for HH, which was a clear manifestation of the parties' intention to create a trust over the Retention Monies; GCC 32.5 did not simply confer a contractual right to require HKA to establish a trust, or to set aside funds to be held on trust.

The court went on to consider the intended subject matter of the trust. It said before a valid trust can come into existence, there must be certainty of the subject matter and the nature of the property must be considered. In this case, the intended subject matter was the sum of money certified as payable to the contractor, HH, and which was to be (and was) withheld by HKA. Although fungible, HH could only identify it as all the money in any and all bank accounts of HKA. There was no other evidence to show that the Retention Monies could be specified with more particularity, as to where the money was held, whether in one specific bank account, or several bank accounts named. A monetary amount of HKA's general funds was all that had been identified, and so the court concluded that there was no certain or identifiable subject matter to be impressed with the trust.

The Retention Monies in this case were said to be the identified part of a larger but identified mass, comprising (according to HH) all the money in all the bank accounts of HKA. The court said that it depended on whether the "mass" or so-called "general funds" could be identified or identifiable, with sufficient certainty. It noted that the mixing of money is not a bar to the existence of a valid trust and the absence of segregation by itself does not mean that there can be no trust intended, or that the subject matter of the trust must be uncertain. The facts of the case and evidence available as to the mass have to be considered. In the present case, GCC 32.5 expressly stated that HKA was to hold the percentage of the certified sum payable to HH as Retention Monies on trust for HH. The purported trust was, the court said, over a part (i.e. the specified percentage) of the bulk of the money or funds of HKA.

It was clear from the authorities and analyses made by academics on co-ownership interests, the court said, that it is important to identify the relevant bulk. If there is no identified bulk, or the property is completely unspecified, problems as to uncertainty may arise. If the transferor is free to choose to select the relevant property from *any* source, then the transferee cannot possibly acquire an ownership interest in any particular bulk, as the situation is simply one of an intended transfer of property which is completely unidentified until the transferor makes the necessary choice and until such identification, it is impossible for the transferee to obtain a property interest.

It was not disputed that HKA had not at any time paid any Retention Monies into any specific account which could be identified. All that could be argued for HKA was that the trust was in respect of all and any of the bank accounts of HKA where its funds were kept. If there had been one, or even more than one but specified bank accounts from which the Interim Payments had been made to HH, it might be argued that the Retention Monies should have been withheld from the funds in these accounts, and form the bulk to be co-owned with HH.

The argument was simply that HKA held \$56,321,000 of its money and funds, on trust for HH. Adopting the co-ownership argument, this meant effectively that HKA held all its money and funds as co-owner with HH. On the argument that it should make no difference from which source or account HKA should allocate the Retention Monies to HH, this may be extended to mean that HKA may, at different times, even allocate particular assets such as its receivables or other debts, of a value equivalent to the Retention Monies, to the trust. This, the court said rendered the subject matter of the purported trust too vague and uncertain, and it would be difficult if not impossible for the court, at the beneficiary's request, to enforce or regulate the trust, by tracing or otherwise.

Court's ruling

The court concluded that for lack of a sufficiently identifiable bulk of which the trust money was said to form part, the trust failed for lack of certainty of subject matter. It said that, bearing in mind that the intended purpose of GCC 32.5 is to protect contractors against the insolvency of the employer, it was unfortunate that the contractor in this case had been deprived of the intended protection as a result of the employer's breach and failure to put the intended trust property into a segregated account. It added that contractors, can only be advised to be vigilant in safeguarding their rights and to apply to the court at an early stage of the project, to ensure that the trust property is preserved and protected, rather than to wait at its own risk in the event that the employer becomes insolvent or the trust property is otherwise dissipated. Accordingly, at the material time of the Scheme, there was no valid trust of the Retention Monies and they formed part of HKA's general assets, to be dealt with in accordance with the terms of the Scheme.

Comments

This judgment highlights the difficulties in recovering retentions from the employer after it has become insolvent. The law in this regard is not straight forward. The standard forms of building contract do not require the employer to produce any proof that the retention monies have been placed in a separate account. Contractors simply do not know whether it has been done and seldom ask for such proof. Contractors following the advice of the judge, reminding contractors to be vigilant in safeguarding their rights and to apply to the court for setting aside the retention in a separate account, may be seen as unduly aggressive by employers, unless an express obligation to produce proof of segregation of retention monies is added to the standard forms of building contract.

Arbitral award found to have been obtained by fraud

Joseph Chung

In *The Federal Republic of Nigeria v Process & Industrial Developments Limited* [2023] EWHC 2638 (Comm), a case before England's Commercial Court, Nigeria successfully challenged arbitral awards under s.68 of England's Arbitration Act 1996 (the Act) on the basis that they had been obtained by fraud, contrary to public

policy. S.68 of the Act is drafted in similar terms to s.4 (2)(g) of Schedule 2 of Hong Kong's Arbitration Ordinance, Cap 609 (AO) and provides for challenges to arbitral awards for serious irregularity, including where the award is obtained by fraud or the award or way it was procured is contrary to public policy.

Background

The parties had entered into a "Gas Supply and Processing Agreement for Accelerated Gas Development" (GSPA), under which Nigeria was to supply "wet" gas to Gas Processing Facilities (GPFs) constructed by *Process & Industrial Developments Ltd (PIDL)*. PIDL was to strip the wet gas into "lean" gas, to be delivered to Nigeria to be used for power generation. A dispute arose and PIDL brought arbitration proceedings against Nigeria. The arbitral tribunal (Lord Hoffmann, Sir Anthony Evans and Chief Bayo Ojo SAN) found that Nigeria had committed a repudiatory breach of the GSPA, that the GSPA was terminated on PIDL accepting that repudiatory breach, and that Nigeria was liable in damages. Under its further award on quantum, Nigeria was ordered to pay PIDL US\$6.6 billion.

Section 68 of the Arbitration Act

Before England's Commercial Court, Nigeria challenged the awards on liability and quantum, under s.68 of the Act, alleging bribery and corruption on PIDL's part, before, at and after the parties had entered into the GSPA.

S.68 of the Act provides: "(1) A party to arbitral proceedings may... apply to the court challenging an award in the proceedings on the ground of serious irregularity affecting the tribunal, the proceedings or the award... (2) Serious irregularity means an irregularity of one or more of the following kinds which the court considers has caused or will cause substantial injustice to the applicant - ... (g) the award being obtained by fraud or the award or the way in which it was procured being contrary to public policy."

In relation to s.68, the court said:

- S.68 is concerned with serious irregularity affecting the tribunal, the arbitral proceedings or the award, with subsection (2) listing nine types of irregularity, the relevant one in this case, being (g), which is concerned with the award and the way in which it was procured.
- For irregularity type (g), it is the award that must be "obtained by fraud"; it is the award or the way in which the award is procured that must be "contrary to public policy". The focus is not on the claim on which the award is based or the cause of action on which the claim is based.
- The s.68 jurisdiction requires a close focus on the parties' conduct in the arbitration and the process by which the award was obtained.
- The objection under consideration in s.68(2)(g), that of "*the award being obtained by fraud or the award or the way in which it was procured being contrary to public policy*", is of fundamental character to the arbitration process because it goes to the integrity of that process.
- An award obtained by fraud or contrary to public policy (or procured in a way that was contrary to public policy) and which has caused or will cause substantial injustice is not what the parties agreed to when they agreed on arbitration.
- Unless the right to object is lost for reasons of finality (see s.73 of the Act), and subject to the procedural restrictions in s.70(2) and (3), there is no sanctuary. This architecture meets the requirements of justice.
- A high threshold is applicable to s.68: Fraud (that is dishonest, reprehensible or unconscionable conduct) must be distinctly pleaded and proved, to the heightened burden of proof.
- As to public policy, it has to be shown that there is some illegality or that the enforcement of the award would be clearly injurious to the public good or, possibly, that enforcement would be wholly offensive to

the ordinary reasonable and fully informed member of the public on whose behalf the powers of the state are exercised.

“Serious” irregularity and “substantial injustice” under s.68

The court said that s.68(2)(g) concerns not just the award being obtained by fraud or being contrary to public policy, but also “*the way in which [the award] was procured being contrary to public policy*”. There could be no question, the court said, that fraud and conduct contrary to public policy are serious in themselves. However, when s.68 refers to seriousness, its focus is on the consequences, and specifically the consequences for justice. It asks whether substantial injustice has been or will be caused to the party applying to the court. There will be substantial injustice, the court said, where it is established that, had the irregularity not occurred, the outcome of the arbitration might well have been different. The court noted that the test of serious irregularity has been recognised as imposing a “high threshold” or “high hurdle” and the focus is on due process, not the correctness of the decision reached.

Court’s findings

The court found that PIDL had paid bribes to a Grace Taiga, former Legal Director at the Ministry of Petroleum Resources, and lawyer involved in the drafting and negotiation of the GSPA on Nigeria’s behalf. The court found that Grace Taiga certainly had a role in bringing about the GSPA and that payments to her and members of her family continued through the arbitration at the instigation of PIDL and also after the arbitral awards, all of which were deliberately concealed from Nigeria.

The court concluded that there was no question that the arbitration would have been completely different, and in ways strongly favourable to Nigeria, had the fact of bribery of Grace Taiga when the GSPA was being made been before the tribunal. It would have brought in the issue whether the GSPA was procured by fraud, and as a result voidable. Discovery of the concealment would have completely altered the tribunal’s approach to the evidence.

Court’s decision

The court concluded that the awards were obtained by fraud and the awards were, and the way in which they were procured, contrary to public policy and that Nigeria had suffered substantial injustice within the meaning of s.68 the Act.

Under s.68(3) of the Act, where there is shown to be serious irregularity affecting the tribunal, proceedings or the award, the court has three options, namely (i) to remit the whole or part of the award to the tribunal to reconsider; (ii) set the whole or part of the award aside; or (iii) declare the whole award or part of it to be of no effect. Here, the court acceded to a request by PIDL’s counsel to postpone the decision as to which order to make until after the parties had had an opportunity to present further arguments in that regard.

The court, by way of endnote to the judgment, said it would be referring a copy of it to the Bar Standards Board, in the case of Mr Trevor Burke KC (Counsel representing PIDL in the arbitration), and to both the Solicitors Regulation Authority and Bar Standards Board in the case of Mr Seamus Andrew (the solicitor representing PIDL in the arbitration), as it found that in the course of the arbitration, PIDL had been provided with many of Nigeria’s internal legal documents, which were protected by legal professional privilege and that Mr Burke and Mr Andrew were amongst those who received them and knew that PIDL and they were not entitled to see them. The court remarked that their decision not to put a stop to it, at least by informing Nigeria or immediately returning the documents they knew were received, was indefensible. The court referred to their significant personal interests in PIDL being successful in the arbitration - up to £850 million in the case of Mr Burke KC and up to £3 billion in the case of Mr Andrew.

Comments

The facts of this case which led to the successful challenge of the arbitral award are extraordinary and attracted a lot of public attention. We will keep readers updated of any developments in the case.

Adjudicator's decision held unenforceable for apparent bias

Justin Yuen

In *AZ v BY* [2023] EWHC 2388 (TCC), England's Technology and Construction Court held that an adjudicator's decision was unenforceable for apparent bias because in the adjudication, he had considered materials relating to negotiations between the parties, which were protected by without prejudice privilege.

Background

The underlying dispute between the parties related to works to replace the stair core pressurisation systems to a building. An issue in the adjudication was whether the contract between the parties in relation to the works was finalised, which the adjudicator ruled it was. AZ brought proceedings to enforce the adjudicator's decision in his favour. BY opposed enforcement on the basis that during the adjudication, AZ had deployed material which was protected by without prejudice privilege. The materials in question, consisted of contractual negotiations between the parties and communications in relation to the contract, including an email and note of a meeting between them, in which it was said that BY had conceded at the meeting that AZ's contractual position was justified.

Without Prejudice Privilege

The Court referred to the law relating to without prejudice privilege, namely:

- The without prejudice rule governs the admissibility of evidence and is partly founded upon the public policy of encouraging litigants to settle their differences, rather than litigate them to the finish and also on the express or implied agreement of the parties that such communications should be treated as confidential.
- The rule applies to exclude all negotiations genuinely aimed at settlement whether oral or in writing from being given in evidence.
- Application of the rule is not dependent upon the use of the phrase "without prejudice" (although it is a strong pointer) and if it is clear from the surrounding circumstances that the parties were seeking to compromise the action, evidence of the content of those negotiations will, as a general rule, not be admissible at the trial and cannot be used to establish an admission or partial admission.
- As a general rule, a document marked "without prejudice" is privileged unless it was not written as part of the process of negotiation or with the intention of promoting compromise.
- The test for determining whether privilege applies is an objective one.
- Whilst parties may be communicating both openly and on a without prejudice basis concurrently, the court must exercise extreme caution in embarking upon a dissection of the communications, or discussions in meetings, so as not to undermine the public policy objective
- The court has to determine whether or not a communication is genuinely intended to be part of or to promote negotiations, by working out what, on a reasonable basis, the intention of the author was and how it would be understood by a reasonable recipient.
- Once a communication is covered by without prejudice privilege, the court is slow to lift the cloak of that privilege unless the case for doing so is absolutely plain.
- There are certain exceptional circumstances where it may be permissible to admit into evidence without prejudice communications which are privileged, namely where the issue is whether without prejudice

communications have resulted in a concluded compromise agreement, in which case, they are admissible. In this situation, the correspondence is admissible, because it contains the offer and acceptance forming a contract which has replaced the cause of action previously in dispute. However, where the without prejudice communications have not in fact resulted in an agreed settlement which has replaced the original dispute about which the parties were negotiating, the decision-maker, having seen the without prejudice material, must then assess their own ability to go on to decide the remaining dispute fairly, in accordance with the principles which govern apparent bias and the rules of natural justice.

Were the materials in question privileged?

The court concluded that the nature of the communications taking place in the documents in question were without prejudice and it followed that the particular documents submitted to the adjudicator about which complaint was made were subject to without prejudice privilege. The court noted that the email in question was not being relied on as collateral, and prejudicial, material seeking to undermine the contractual position which BY had adopted. In essence, it was being said that BY had conceded i.e. agreed in the meeting that AZ's contractual position was justified. Use of without prejudice material, the court said, is not admissible for these purposes. The exception to the without prejudice rule is generally not invoked unless the agreement said to have come into existence is one which has replaced the underlying dispute which was the subject of without prejudice negotiations.

Without Prejudice Communications and Apparent Bias

The court referred to the test as to whether there is apparent bias present, namely whether, on an objective appraisal, the material facts give rise to a legitimate fear that the adjudicator might not have been impartial. The court on any enforcement proceedings should look at all the facts which may support or undermine a charge of bias, whether such facts were known to the adjudicator or not.

The court said that it is the existence of the "question mark" which is being addressed by the objective apparent bias test. Thus, concluding that such a question mark exists does not depend on establishing that the decision was "primarily decided" on the basis of the without prejudice material.

The question of admissibility, the court said, is a question of law and generally, adjudicator's decisions will be enforced notwithstanding that they contain an error of law. However, an error as to the admissibility of without prejudice material is an error of law that could potentially impact the fairness of the decision-making process in accordance with the rules of natural justice and which can affect the enforceability of the decision. If, therefore, a court concludes (contrary to the determination of the adjudicator) that material was in fact without prejudice *and* that the test of apparent bias is made out, the decision should not be enforced. This, the court said, accords with the important public policy behind without prejudice communications, and, is consistent with the court's strong discouragement to parties from deploying "without prejudice" communications in adjudication.

The court concluded that there was apparent bias in this case because the fair-minded and informed observer considering all of the circumstances of this case would conclude that there was a real possibility that, having seen the without prejudice material, the adjudicator was unconsciously biased, since:

- The without prejudice material was placed front and centre within the Adjudication by AZ, and played a significant role in AZ's case.
- That material contained implicit admissions by BY that were plainly inconsistent with its open position and the contractual position it was arguing for in the adjudication.
- As such, the material was not just prejudicial and adverse to its interests but also related to central issues in dispute.
- Regardless of the manner in which the decision was expressed, there was in the circumstances of this case an inevitable question mark about whether the result of the adjudication, however inadvertently or

sub-consciously, was shaped by the adjudicator's knowledge of the concessions/admissions in relation to key aspects of the open dispute made by BY in negotiations.

- The inevitable question mark was even more acute when the adjudicator had formed the view, also in error, that these matters had in fact been agreed.

Comments

This judgment provides a useful summary of the court's approach in dealing with privileged materials. It also highlights the risks which the party who relies on privileged materials has to take in adjudication (or other arbitration/legal proceedings). If apparent bias is established, any decision of the adjudicator or the arbitrator/court may be unenforceable.

Deacons Construction team maintains its Band 2 ranking in Chambers Greater China Region Guide 2024

We are pleased to announce that Deacons' has maintained its Band 2 ranking for Construction in the 2024 Chambers Guide and that partners, KK Cheung and Joseph Chung and consultant, Stanley Lo, are named as Notable Practitioners in the construction field. This is what clients are quoted as saying about the practice:

"Deacons provide a good service and are prompt in their dealings. I particularly appreciate their quick responses."

"All members I have dealt with at all levels are proficient and knowledgeable. Responses were also provided in a timely manner."

KK Cheung and Joseph Chung are recognised in Who's Who Legal Hong Kong 2023: Construction

We are delighted to announce that our Construction Partners **KK Cheung** and **Joseph Chung** are recognised in **Who's Who Legal (WWL) Construction 2023**.

In WWL Construction, lawyers are selected for their outstanding experience and expertise in resolving complex multi-jurisdictional construction disputes through litigation, mediation and arbitration.

Want to know more?

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