

HONG KONG COURT OF PRACTICAL VIEW ON THE UPHOLDING A LIQUIDATED

In the recent case of *Brio Electronic Commerce Limited v Tradelink Electronic Commerce Limited* CACV 271/2013, the Hong Kong Court of Appeal (CA) held that a clause in the contract setting a sum of HK\$5 million as liquidated damages in relation to an obligation of non-solicitation was not a penalty and was therefore enforceable. The CA affirmed the century-old traditional legal test for determining whether a clause is a liquidated damages clause – i.e., whether a clause that took effect on breach was a "genuine pre-estimate of loss" and therefore compensatory, or whether it was aimed at deterring a breach and therefore penal (*Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79). In that regard, Hong Kong law now diverges from the latest position in England, which has recently over-ruled *Dunlop*.

Despite this recent development on the rule on penalties in England (click [here](#) and [here](#) to read our previous posts on the new rule on penalties in England), Hong Kong courts have not yet followed suit. Nevertheless, it does appear that the Hong Kong Courts are more open to the idea of taking a broad approach, which may have implications for parties entering into commercial contracts in Hong Kong going forward.

Background

Both the plaintiff and the defendant operated in a niche market of providing electronic trade declaration facilities. In 2003, the Government increased competition in the market by issuing a new licence. The plaintiff and the defendant

entered into an agreement where the plaintiff agreed to cooperate solely with the defendant and not with the defendant's new competitor. The defendant ensured that none of the plaintiff's clients would connect with the service provided by the defendant's competitor, while the defendant agreed not to seek to persuade the plaintiff's customers from leaving the plaintiff to use the defendant's own services instead.

In 2006, the defendant poached two of the plaintiff's most important customers. The dispute was resolved by settlement with the defendant paying the plaintiff about HK\$1.9 million and entering into a second agreement. The second agreement was similar to the first agreement, but there was a liquidated damages clause of HK\$5 million in the second agreement. The plaintiff brought an action against the defendant for breach of the second agreement.

At the Court of First Instance, the defendant contended that the liquidated damages clause was a penalty and was therefore unenforceable. The defendant's argument was rejected by the lower court on the basis that, among various things, the second agreement was a commercial agreement entered into by parties who were very familiar with the trade, the agreement was made only after lengthy negotiations, and that the agreed amount of HK\$5 million was the parties' best pre-estimate of the damages that were likely to be suffered in the event of a breach of the contractual obligations, the amount of which was not extravagant or unconscionable.

IF AN APPEAL TAKES A THE PENALTIES RULE THE LIQUIDATED DAMAGES CLAUSE

- Gareth Thomas, Dominic Geiser, Priya Aswani

The defendant appealed. At the CA, the defendant argued that since the second agreement was entered as part of the settlement of the breach of the first agreement, the liquidated damages clause in the second agreement should be regarded as an attempt to deter the defendant from breaching its contractual obligations again, and was thus a penalty and was unenforceable. The CA too, rejected the defendant's argument and held in favour of the plaintiff.

Decision

In arguing for an unenforceable penalty clause, the defendant referred to the *Dunlop* case and then further suggested that assistance be derived from the approach in *Murray v Leisureplay Plc* [2005] EWCA Civ 963, where Arden LJ set out a five-stage test to determine whether a clause was a penalty:

- i. *To what breaches of contract does the contractual damages provision apply?*
- ii. *What amount is payable on breach under that clause in the parties' agreement?*
- iii. *What amount would be payable if a claim for damages for breach of contract was brought under common law?*
- iv. *What were the parties' reasons for agreeing the relevant clause?*
- v. *Has the party who seeks to establish that the clause is a penalty shown that the amount payable under the clause was imposed in terrorem, or that it does not constitute a genuine pre-estimate of loss for the purposes of the Dunlop case, and, if*

he has shown the latter, is there some other reason which justifies the discrepancy between (ii) and (iii) above?

The CA rejected the restrictive approach in *Murray*. Instead the CA cited an earlier Hong Kong case *Ip Ming Kin v Wong Siu Lan* (unreported, 28 May 2013, CA, CACV 201/2012) as support for adopting a broader approach. If the Court had adopted the restrictive approach in *Murray*, it would have been necessary to adduce evidence and calculate damages. The CA held this would have been inconsistent with the purpose of a liquidated damages clause, which was precisely to dispense with the need to adduce evidence and calculate damages.

It is not clear whether in adopting the broader approach the Court would go as broad as the approach taken in *Cavendish Square Holding BV v Talal El Makdessi; ParkingEye Limited v Beavis* [2015] UKSC 67, which now represents the current law on penalty clauses in England & Wales. The Supreme Court found that penalty clauses should be determined based on whether the innocent party's legitimate interest in enforcing the counterparty's contractual obligations were "out of all proportion". While it could be potentially more flexible than the traditional test, the *Cavendish* test has not been formally considered by the Hong Kong Courts.

Hence, the traditional "genuine pre-estimate of loss" test from *Dunlop* and its guidelines remain in place at least for the time being. Even so, the CA in *Brio* did consider that the

HONG KONG COURT OF APPEAL TAKES A PRACTICAL VIEW ON THE PENALTIES RULE UPHOLDING A LIQUIDATED DAMAGES CLAUSE CONT

determination of a penalty clause was "a question that should be considered in broad and general terms". This may prompt future decisions to move towards Cavendish.

The key takeaways

- ✓ The law on penalty remains as it has been for Hong Kong contracts.
- ✓ Consider at the stage of negotiating a liquidated damages clause whether the amount stipulated in the clause is a genuine pre-estimate of the loss that is likely to occur.
- ✓ Where a genuine pre-estimate is not possible, consider whether the amount can be commercially justified.
- ✓ Be sure to maintain a record of all the negotiations (oral and written) and the commercial factors that the parties have considered which go to justifying the stipulated amount.
- ✓ Where possible, avoid a single amount that is payable irrespective of whether the loss is minor or of a greater magnitude.

"This article first appeared on Asia Disputes Notes, Herbert Smith Freehill's free online blog page which covers the latest developments in Disputes across Asia. For more information, please go to <http://hsf-asiadisputesnotes.com/>."



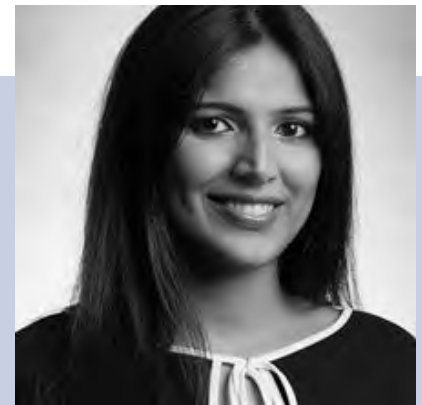
Gareth Thomas
Partner, Dispute Resolution

Gareth is a commercial and insurance litigator with wide-ranging experience in disputes, arbitration and mediation matters. His expertise in dispute matters covers banking, commercial contracts, defamation, employment, fraud, insolvency, negligence, product liability, restraint of trade and shareholders' disputes, as well as cases involving bonds, structured products and other derivatives.



Dominic Geiser
Partner, Dispute Resolution

Dominic specialises in general commercial litigation, and has extensive experience of advising banks, financial institutions, private equity firms, corporates and high net worth individuals on a range of contentious matters, often with a cross-border element.



Priya Aswani
Professional support lawyer

