ADR | Partnership
Partners in Alternative Dispute Resolution

Digest

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Welcome

In 2012, Drainage Services Department completed a pilot scheme on NEC3 on a drainage project. The Hong Kong Government has since committed to expanding the pilot scheme in NEC3 and it is understood that Works Department will generally adopt NEC3 in all public works contracts for tenders first gazetted in 2015 and 2016. The aims are to provide a much more collaborative and pro-active way of working where matters are dealt with in a prospective and ongoing manner. However, guest writers Steven Walker QC and David Johnson of Atkin Chambers question whether this 'prospective' focus in NEC3 is lost, and consistency undermined, as a result of a number of provisions that fail to employ a truly forward-looking approach but rather permit (or even encourage) parties to adopt a retrospective approach that the contract is ill-prepared to accommodate.

At the end of 2015, the English Supreme Court in the case of *Cavendish Square v El Makdessi*, issued a comprehensive decision on penalty clauses and liquidated damages. We are pleased to have Nick Longley, Partner of Holman Fenwick Willan as our second guest writer to review the dramatic effects that this may have on the enforceability of liquidated damages.

Kung Hey Fat Choy!

James B Longbottom
Managing Director

Looking in the Right Direction? The Philosophy of NEC3

By **Steven Walker QC**
and **David Johnson**
Barristers, Atkins Chambers

Introduction

The current edition of NEC3 published in April 2013 includes a preface by the originator of the NEC contract, Dr Martin Barnes CBE:

> *"The NEC contracts are the first to deal specifically and effectively with management of the inevitable risks and uncertainties which are encountered to some extent on all projects. Management of the expected is easy, effective management of the unexpected draws fully on the collaborative approach inherent in the NEC contracts."*

The quotation above is demonstrative of the philosophy (itself made clear by the somewhat unusual present tense wording of obligations the contract form employs) underpinning NEC3; namely, that matters will be dealt with on an ongoing basis as they arrive and not stored up until the end of the project. However, we consider this 'prospective' focus is lost, and consistency undermined, as a result of a number of provisions that fail to employ a truly forward-looking approach but rather permit (or even encourage) parties to adopt a retrospective approach that the contract is ill prepared to accommodate. Not only that, but the effect is that

commercial resources are "front loaded" under NEC3, which may detract from the focus on completion of the project itself and lead to greater expenditure being incurred by all parties.

The traditional approach has been to leave the party to whom a risk is allocated to manage that risk on its own in order to protect its commercial position. This is where NEC3 is different.

Risk Management

The principal function of a contract is to allocate risk. In the NEC forms, risk is allocated in a traditional way. Events that are at the employer's risk are called 'compensation events': the contractor is entitled to time and cost adjustment when a compensation event occurs. Other events are at the contractor's risk. The traditional approach has been to leave the party to whom a risk is allocated to manage that risk on its own in order to protect its commercial position. This is where NEC3 is different. The last sentence in the quotation above perhaps best encapsulates one of the features of NEC contracts that differentiates them from other forms of construction and engineering contract: the inclusion in the contract terms of provisions that require the parties to collaborate in the management of risk.

The NEC is intended to change the culture of construction from an adversarial one to that where all involved in the project, the stakeholders, manage risk together irrespective of contractual risk allocation. That risk management is promoted by, among other things, the following provisions which are core provisions found in all of the different options:

- The obligation to act in a spirit of mutual trust and cooperation.
- Early warning notice provisions to promote collaborative risk management.
- The creation and maintenance of the Risk Register.
- The requirement for the submission of a detailed programme. We address this in more detail below because it is essential for the form to operate as intended. In our experience, its absence is a source of uncertainty and, frequently, disputes.
- The obligation on the Project Manager to accept the programme or give reasons for non-acceptance.
- The early assessment of compensation events in terms of their effect on time and cost using forecasts of the likely effect of such events, rather than postponing assessment until after completion. Again, we address the operation of these provisions in theory and in practice below.

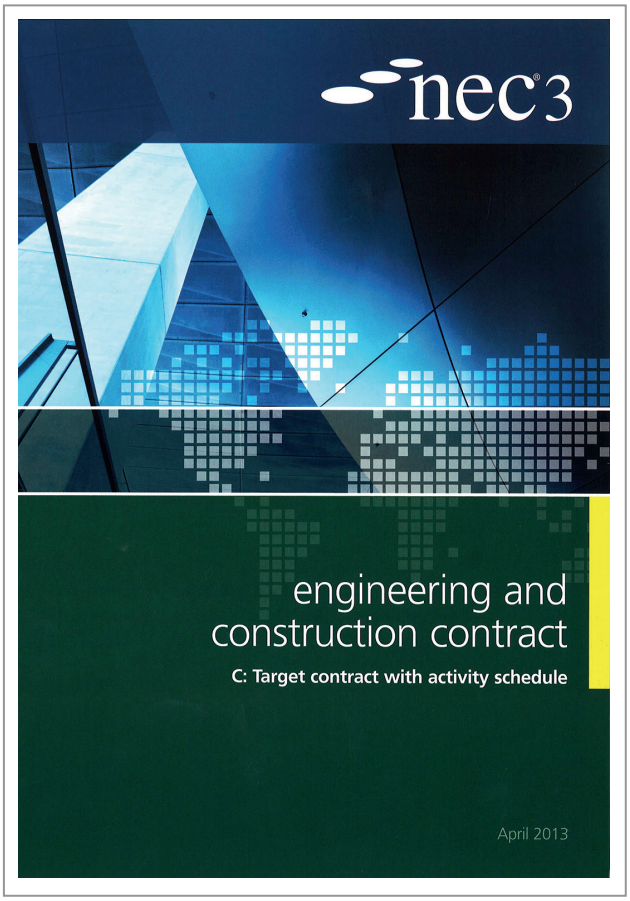
1. The Accepted Programme

The importance of the Accepted Programme in NEC3 cannot be underestimated. The contents of the programme are prescribed by clause 31.2 and are, as that clause demonstrates, relatively extensive.

It will often be impractical to produce a fully logic linked programme with planned resources at tender stage and NEC3 does not require this. Instead the programme may be submitted after commencement. As work proceeds the contractor is required to update the programme at regular intervals so that it provides an adequate programme for the management of the works at the time when it is issued. At the start of a development it may not be necessary to provide details of how the fitting out and snagging will be conducted. It will, however, be necessary to plan in considerable detail any outstanding design activities and their link to the construction activities and to detail the early works such as demolition, excavation, piling and the like.

The Project Manager has two weeks in which to accept each programme submitted by the contractor or reject it for one of the four reasons stated in clause 31.3. This requires the Project Manager to have available sufficient skilled programmers to interrogate the programme, which may not be a straightforward task.

In an ideal world therefore, under NEC3 the programme is the document that holds the project together and this is kept under tight control with the regular programme revisions. Experience shows, however, that a lack of Works Information (namely design information and construction information) can make it difficult for the contractor to produce an adequate programme. Some contractors simply do not have the skills to produce a satisfactory programme. It is also the case that some Project



In an ideal world... under NEC3 the programme is the document that holds the project together and this is kept under tight control with the regular programme revisions. Experience shows, however, that a lack of Works Information (namely design information and construction information) can make it difficult for the contractor to produce an adequate programme.

Managers do not have the skills to interrogate a programme in order to determine whether it is acceptable or not.

Particularly given the extensive requirements of clause 31.2, it is not uncommon for disputes to occur as to whether or not a programme that has been rejected by the Project Manager should have been rejected. This gives rise to uncertainty in relation to the management of the works and the assessment of compensation events. In the case of the latter it is not uncommon for the contractor to base its assessment of an event on its programme whilst the Project Manager makes an assessment based on his (completely different) programme for the remaining work.

2. Assessment of Compensation Events

Notice Provisions

One of the aims of NEC3 is to see to it that compensation events will be dealt with contemporaneously and as quickly as possible during the project. Unlike most contracts, there are no provisions for a final account process or for extension of time claims to be assessed after completion. NEC avoids use of the word *"claim"* (except in relation to insurance). Instead, there are a number of means by which the value of the *"Prices"* under the contract may be affected. Compensation events are one such example.

NEC3 requires the Project Manager to notify some compensation events itself. Clause 61.3 requires the contractor to notify the Project Manager of an event which has happened or which he expects to happen as a compensation event within eight weeks if the contractor believes that the event is a compensation event and the Project Manager has not notified the event to the contractor *"unless the event arises from the Project Manager or the Supervisor giving an instruction, issuing a certificate, changing an earlier decision or correcting an assumption."*

The eight-week period starts when the contractor is *"aware of the event"*. This suggests that:

(i) the contractor must have actual awareness of the event;
(ii) that the event is a compensation event; and
(iii) that the Project Manager has not notified the event.

Constructive knowledge does not appear to trigger the notice period.

However, the proviso in Clause 61.3 refers to events that the Project Manager should have notified. As a result of the proviso, the time bar in NEC3 will often not apply in practice. This sits uneasily with the aim of ensuring that compensation events are dealt with speedily. NEC3 contains strict deadlines for the assessment of compensation events. However, the contractor does not appear to suffer any detriment for failure to submit a timely notice of a compensation event where the event is one that the Project Manager was required to notify. The result is that assessment of a compensation event could be required to take place long after the event occurred, which does not appear to square with the other provisions of NEC3.

The proviso has been the subject of case law in the UK: *Northern Ireland Housing Executive v Healthy Buildings [2014] NICA 27*. The decision in the Northern Ireland Court of Appeal confirms that, contrary to the general intention of NEC3, the proviso to clause 61.3 does permit contractors to submit compensation event notices long after the compensation event occurred on those many cases where the Project Manager should have given notice. It should be noted that this is contrary to the view offered by the authors of Keating on NEC3, who express support (at paragraph 7-082) for the view that a contractor that does not give notice under 61.3 is precluded from claiming a contractual entitlement to claim an extension of time or a change to the Prices.

It is common for employers to delete the proviso and where this is done it places the onus on the contractor to notify compensation events within time or lose its entitlement to an adjustment of price and time. This is, in our view, far more consistent with the aim of promoting the early resolution of matters affecting time and price. Contractors must then heed the absence of the proviso and ensure that claims are made on time. Employers, accordingly, are not subjected to claims submitted long after the event and are given increased certainty of their position as a result of the eight-week time bar.

The Assessment of Compensation Events

We observed above that there are no provisions for the submission and assessment of a final account. Again, the intention of NEC3 appears to be that events will be assessed as the project proceeds thereby (theoretically at least) providing the parties with certainty as to the outcome. The certainty may however prove illusory where the Project Manager has made assessments as the contractor may dispute those assessments at a time of its choosing (subject to limitation periods).

The process for assessment involves the contractor in submitting a quotation identifying the actual or forecast effect of the compensation event. In relation to the assessment of time, clause 63.3 provides as follows:

> *"A delay to the Completion date is assessed as the length of time that, due to the compensation event, planned Completion is later than planned Completion as shown on the Accepted Programme."*

Some users of NEC3 take the view that the above clause requires the compensation event to be *"impacted"* on the Accepted Programme and that the result derived from that impacting is the assessment of the likely effect of the compensation event. Whilst this may be an entirely appropriate means of assessment in some cases we consider it will not be appropriate in every case and may lead to difficulties.

Firstly, it may be reasonable to make the assessment after making alterations to the Accepted Programme. In this regard clauses 63.6 and 63.7 are relevant:

63.6 Assessment of the effect of a compensation event includes risk allowances for cost and time for matters which have a significant chance of occurring and are at the contractor's risk under this contract.

63.7 Assessments are based upon the assumption that the Contractor reacts competently and promptly to the compensation event, that any Defined Cost and time are due to the event are reasonably incurred and that the Accepted Programme can be changed.

A competent reaction may include re-sequencing the work to mitigate delay. Equally, the contractor is entitled to add time for risks that are allocated to it. This too may require a departure from the approach described above of simply impacting the event into the Accepted Programme. The assessment may require the Accepted Programme to be adjusted.

In respect of financial claims, clause 63.1 provides that:

63.1 The changes to the Prices are assessed as the effect of the compensation event upon;

- ***The actual Defined Cost of the work already done***
- ***The forecast Defined Cost of the work not yet done and***
- ***The resulting Fee***

The date when the Project Manager instructed or should have instructed the Contractor to submit quotations divides the work already done from the work not yet done.

These clauses indicate that the assessment is expected to be prospective but they do not demand a prospective assessment where, for example, the assessment is being made after the works are complete as commonly occurs in practice, whether for the reasons identified above or where the contractor disputes an assessment of one or more compensation events. Attempts to *"turn the clock back"* and use prospective methods after the works are completed are often seen. The attempt to make a forecast after completion is not only counter-intuitive; it can be hugely speculative, time consuming and costly, as countless permutations are addressed in circumstances where an examination of actual events might provide a more straightforward and more realistic means of assessing the delay to planned completion and the additional cost due to the compensation event.

In one recent dispute the authors defended an employer in circumstances where a contractor sought to advance extensive compensation event claims based on 'forecasts' of costs made many months (and in some cases) years previously. It is obviously in a contractor's interests to ensure that a forecast is generous since the quotation will take into account the numerous eventualities that may (or, of course, may not) arise in the course of a project. However, we would suggest it is another matter altogether to proceed on the basis of that same forecast months down the line where (i) those eventualities have not arisen, and (ii) the actual costs incurred are by that time known.

Assessment Using Forecasts Based On Assumptions

It may not always be possible to make a reasonable forecast the time reasonably incurred due to a compensation event and the contract therefore provides as follows:

61.6 If the Project Manager decides that the effects of a compensation event are too uncertain to be forecast reasonably, he states assumptions about the event in his instruction to the Contractor to submit quotations. Assessment of the event is based on those assumptions. If any of them is later found to have been wrong, the Project Manager notifies a correction.

The clause requires a correction to be notified if the assumption is later found to have been wrong. This introduces a retrospective element to the assessment of time and involves a factual inquiry as to what in fact occurred. If the facts show that the assumption was wrong, the correction is a compensation event. That later compensation event, the *"correction event"*, has then to be assessed. The issue that arises and on which the contract is silent is which programme to use to make that assessment: the Accepted Programme current at the date of the assessment, or the Accepted Programme current at the date of the first assessment that used the assumption? There is no case law on this point. The answer may significantly affect the assessment of any extension of time and cost in a given case. It should be noted that there is no provision to reduce an extension of time even if the effect of the correction is that the EOT assessed using assumptions is more than would not have been assessed had the facts been known.

Conclusions

NEC3 requires collaboration in relation to the management of risks and the deployment of sufficient planning and management expertise by both the contractor and the employer's Project Manager. This adds cost and is likely to make the project more expensive. This additional investment is intended to deliver a reduction in risk to both parties and the avoidance of costly disputes through the early assessment of compensation events. NEC3 requires the effect of compensation events to be forecast but the extent to which that is required or appropriate in cases where events are being assessed long after the events occurred and their effects are known or ascertainable is open to question.

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Cavendish Square v El Makdessi – Liquidated Damages: The New Law

By **Nick Longley**,
Partner, Holman Fenwick Willan

Introduction

At the end of 2015, the highest court in the UK, the Supreme Court, issued a comprehensive decision on penalty clauses and liquidated damages. It has been said that this decision, the Cavendish Square Decision, will dramatically change the law on the enforceability of liquidated damages. Nick Longley, a partner in the Holman Fenwick Willan construction team, reviews the decision and assesses the effects of the new law. This article:

(i) explains the meaning of liquidated damages and penalty clauses; and
(ii) assesses the new Supreme Court decision and its effects.

What are Liquidated Damages Clauses?

Liquidated damages clauses are contractual clauses providing for the payment of a specified (or liquidated) sum of money for a specific breach of contract. The specified sum is written into the contract. The primary purpose of a liquidated damages clause is to provide a certain remedy to an Employer in the event of a breach of contract by a Contractor.

Usually, liquidated damages clauses will specify the amount of damages payable in the event of delay on a per day or per week basis. Liquidated damages clauses have significant advantages to Employers, including:

(i) The Employer is not required to prove its actual loss of delay, which in many circumstances could be very difficult.
(ii) The Employer does not need to wait to incur losses before imposing liquidated damages.
(iii) The Employer is under no obligation to mitigate its losses.

There are also advantages to the Contractor, which include:

(i) The Contractor has much greater certainty when pricing the risk of delay.
(ii) Depending on the wording of the contract, liquidated damages may act as a cap on liability, preventing the Employer from also claiming general damages.

What is a Penalty?

In legal terms, a *"penalty"* is a punishment for non-observance of a contractual obligation. A penalty involves imposing an additional or different liability as a result of a breach of contract.

As a matter of common law, it is contrary to public policy to impose penalties for breach of contract. This public policy rule can be seen as an exception to the usual rule of contract, which is to give the parties the freedom to contract to do whatever they like.

The distinction between penalties and liquidated damages is highlighted in the extremely well known 1915 court decision of Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd*. In fact, the well known phrase that liquidated damages must be a *"genuine pre-estimate of loss"* was coined in that case.

Lord Dunedin set out four *"tests"* as to whether a liquidated damages clause could be considered to be a penalty. They were:

(i) The sum must not be extravagant and unconscionable in comparison to the *"greatest loss"*;
(ii) The clause is likely to be penal if breach was for non payment and the provision provided for a greater sum to be paid;
(iii) A single sum for both serious and trivial breaches is likely to be presumed penal; and
(iv) A liquidated damages clause will not be considered penal simply because it is impossible to estimate the loss.

"The penalty rule is an ancient, haphazardly constructed edifice which has not weathered well."

Lord Neuberger

Cavendish Square Holdings B.V v Talal El Makdessi

The Supreme Court in England has now restated the law on liquidated damages. As a result, the phrase *"genuine pre-estimate of loss"* may completely disappear from claims submissions.

The Supreme Court convened a seven judge panel to consider the Cavendish Square decision. This in itself is rare. Usually a Supreme Court will consist of a panel of five judges. In fact, the judgment dealt with two separate and very different cases: *Cavendish Square Holdings B.V v Talal El Makdessi* and *ParkingEye Limited v Beavis*. Neither of these cases concerned construction, but the facts of both are highly relevant and very interesting. They are set out below.

Cavendish Square v El Makdessi

This dispute arose from a share purchase agreement for a marketing company based in the Middle East. The sale price was to be paid in four installments, of which two installments were deferred. The seller was subject to a *"non-compete"* clause. If the seller breached the non-compete clause then:

(i) the seller lost the rights to the final two installments of the purchase price, which were deferred; and
(ii) the seller lost the rights to sell his remaining shares at a defined price. Instead, a *"call option"* was triggered, which allowed the purchaser to buy the remaining shares at a *"net asset value"* which provided no value for good will.

In fact, the seller, El Makdessi, breached the non-compete clause by establishing another marketing company. The English High Court enforced the clause but the Court of Appeal refused to do so on the basis that it was a penalty. The Supreme Court overturned the Court of Appeal's ruling and decided that the non-compete provision did not act as a penalty.

"The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories."

Lord Neuberger

ParkingEye Limited v Beavis

At the other end of the commercial spectrum, the *ParkingEye Limited v Beavis* case arose from an £85 parking fine for overstaying a shopping centre's two hour free parking limit.

ParkingEye were the operators of the car park but were not the owners. ParkingEye's only revenue was from parking fines. It was clear that there was no loss to ParkingEye (or indeed the owner of the car park) by car owners overstaying the two hour limit. Indeed, ParkingEye conceded at trial that the £85 fine was not a genuine pre-estimate of loss.

Both the English High Court and the Court of Appeal upheld the parking fine. Mr Beavis appealed.

The Supreme Court's Decision

The Supreme Court conducted a complete review of the law on liquidated damages and penalties. In fact, Cavendish's primary argument was that the Supreme Court should abolish the concept of penalty clauses altogether. It was argued that the public policy against enforcement of penalties was outdated and unnecessary, at least in a commercial contract. The Supreme Court considered this but decided that the prohibition against penalties was too deeply entrenched to discard.

However the Court considered that the emphasis on the phrase *"genuine pre-estimate of loss"* from the Dunlop Tyres decision was unfortunate, and instead emphasized the other aspects of the Dunlop Tyres decision.

In doing so, the Supreme Court restated the test for liquidated damages. The test set out in the leading joint judgment of Lord Neuberger and Lord Sumption is that a liquidated damages sum will be considered to be a penalty if it is *"out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation."*

In a separate judgment, Lord Hodge (with whom Lord Toulson agreed), stated the test as:

> *"whether the sum or remedy stipulated as a consequence of the breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in performance of the contract."*

Under the new test, there are two questions that need to be considered:

1. Is there a legitimate interest to be protected?
2. Is the remedy, exorbitant, unconscionable or out of all proportion to the interest?

A liquidated damages provision will only be considered a penalty if the answer to the first question is no or if the answer to the second question is yes.

Applying this test to the facts of the two cases, Cavendish Square had a legitimate interest in enforcing the non-compete provision. The court decided that treating the clause as invalid would amount to re-writing the contract. This was despite the fact that there was no relationship between loss and breach. Mr El Makdessi lost just over US$ 44 million.

In ParkingEye, the concept of a legitimate interest was very wide. It included establishing a regime for efficient parking for the benefit of shop owners and shoppers alike and extended beyond the interests of the contracting party, ParkingEye. The court decided that the fine itself was neither extravagant nor unconscionable having regard to fines charged by others, such as local authorities. Mr Beavis was required to pay his £85 parking fine.

What has Changed?

The Supreme Court's decision will no doubt make it harder to challenge the quantum of liquidated damages for delay. However, in reality it has been difficult to challenge the amount of liquidated damages for quite some time.

The Supreme Court's decision has also confirmed that the law on penalties applies not only to clauses which specify a sum of money to be paid but also to clauses specifying the transfer of assets, such as shares.

The new law may, however, also lead to the use of clauses applying liquidated damages to breaches of secondary contractual obligations. Up until now, liquidated damages have generally been limited in their application to major breaches such as failing to complete on time or a failure to comply with performance guarantees. However, in Hong Kong it has been common for some time to allow for liquidated damages for breaches of health and safety rules, notwithstanding the lack of clear link between breach and loss. These sorts of clauses now have clear legal legitimacy. It is possible that they will extend into other areas, such as a sum per day for failing to provide a properly qualified foreman.

In the wake of these changes to the law, contractors may increasingly find imaginative ways to impose liquidated damages for breaches of secondary contractual obligations. In light of the new wider interpretation of a legitimate interest resulting from ParkingEye, provided the sum claimed is not exorbitant or out of all proportion to the maximum loss that could be incurred, this sort of practice is likely to be more common, and more willingly accepted by the courts and arbitrators.

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ADR | News

ADR Annual Cocktails at the China Club, 4th June 2015












Britcham "In the Mood for a Jolly Good Jive!"

On 12th June 2015 ADR and its guests were transported back to 1940/50's Britain at the height of the big band era in a swing dancing themed Britcham and Standard Chartered Ball, held at the Grand Hyatt Hotel in support of KELY Support Group.

KELY Support Group is a local charity which provides youth support in drug and alcohol prevention. Further information can be found at: ***www.kely.org***







ADR | News

Adjudication Training and Accreditation Programme

Under the Hong Kong Government's proposed Security for Payment Legislation the HKIAC will be the proposed defaulting body for nominations of adjudicators for statutory adjudicators unless the contract provides expressly that a different body is to nominate or the parties agree on a specific adjudicator. The HKIAC therefore ran a training course in September and October 2015 to create a panel of adjudicators for when the legislation is enacted. We are pleased to note that James Longbottom, Managing Director of ADR Partnership has successfully passed the course for inclusion on the panel.

ADR | Diary

Forthcoming Events 2016

11 Mar	*RICS Annual Dinner – Grand Hyatt Hong Kong*
18 Mar	*The Lighthouse Club Safety Leadership Award – The Hong Kong Club*
8-10 Apr	*Rugby Sevens*
27-28 May	*The Lighthouse Club: Two Day International Conference and Exhibition – Hong Kong Convention & Exhibition Centre*
27 May	*The Lighthouse Club International Design for Safety Awards and Cocktail Reception*
28 May	*The Lighthouse Club Anniversary Ball*
16 Jun	*ADR Cocktail Party – The China Club*

ADR | Analysis

Labour Shortage and Wage Inflation

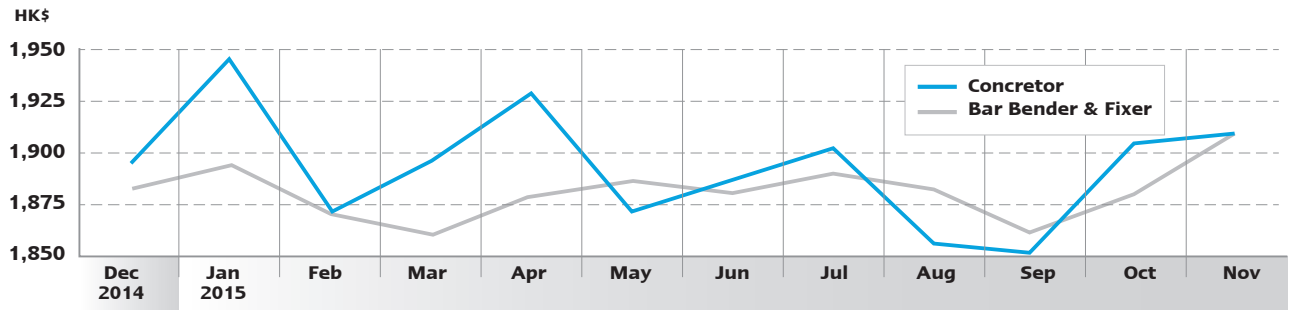
"On average, concrete workers get paid HK$2,300 a day and bar benders HK$1,930, a survey by the Construction Industry Employees General Union showed last month."

SCMP November 2015

"The shortage of construction workers in Hong Kong is the mother of all shortages."

C Y Leung, Joint Business Community Luncheon, February 2015

Concretor and Bar Bender & Fixer Average Daily Wages (Hong Kong Census & Statistics Department)



Based in Hong Kong, ADR Partnership Limited is a dynamic practice of construction professionals providing specialist commercial and contractual services to the construction industry.

If you would like to discuss any of the articles published in this *Digest* or your project requirements, please contact James Longbottom, Patrick O'Neill or David Longbottom at ADR Partnership Limited on **(852) 2234 5228** or e-mail us at **info@adrpartnership.com**

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