

## THE DOCTRINE OF PENALTIES IN HONG KONG: COURT OF APPEAL CLARIFIES TEST AND ADOPTS A MODERN APPROACH

A recent decision of the Court of Appeal, *Law Ting Pong*, has confirmed that the test set out in *Cavendish Square* applies in Hong Kong. This provides welcome certainty and brings Hong Kong in line with the position under English law. The *Cavendish Square* test is generally considered to be more commercial and practical than the *Dunlop* test that previously applied, which may benefit parties to complex commercial contracts in financing or M&A transactions.

### THE DOCTRINE OF PENALTIES ACROSS ASIA PACIFIC

The general principle is that a contractual clause will be considered a 'penalty' and therefore invalid, inoperative and unenforceable if it is designed to deter breach rather than provide for genuine compensation. While courts will not substantively review private contracts or re-write the terms of such contracts, there is a public policy justification for limited intervention to prevent penalties which are 'unconscionable' in nature.

As discussed below, the traditional test in *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co*<sup>1</sup> (**Dunlop**) meant a liquidated damages clause (or relevant secondary obligation) would only be enforceable if it constituted a genuine pre-estimate of loss. The reformulated test in *Cavendish Square Holding BV v Talal El Makdessi and ParkingEye Ltd v Beavis*<sup>2</sup> (**Cavendish Square**) is to consider whether the clause is proportional to the innocent party's legitimate interest in performance of the contract.

In a previous [briefing](#), we reported on the *Denka v Seraya* decision of the Singapore Court of Appeal, which rejected the *Cavendish Square* legitimate interest test and conclusively confirmed that Singapore law adopts the *Dunlop* genuine pre-estimate of loss test. That briefing included a summary of the position on penalties in major common law jurisdictions and an updated version in light of the recent Hong Kong Court of Appeal decision in *Law Ting Pong Secondary School v Chen Wai Wah*<sup>3</sup> (**Law Ting Pong**) is on the last page of this briefing. In short, there is now inconsistency across the region

#### Key issues

- The doctrine of penalties renders unenforceable secondary obligations that are penal in nature, rather than compensatory.
- The position under English law was revisited in a landmark decision in 2015, which established the *Cavendish Square* test, which considers proportionality to the innocent party's legitimate interest in performance of the contract. This test is widely considered to be less interventionist and more practical for commercial parties.
- A recent judgment of the Court of Appeal confirmed that Hong Kong applies the *Cavendish Square* test.

<sup>1</sup> [1915] AC 79

<sup>2</sup> [2015] UKSC 67

<sup>3</sup> [2021] HKCA 873

with Hong Kong following the UK Cavendish Square approach, Singapore maintaining the Dunlop approach, and Australia not having identified a clear test. Parties should keep these jurisdictional differences in mind when selecting the law to govern each contract.

## **THE TRADITIONAL DUNLOP TEST: GENUINE PRE-ESTIMATE OF LOSS**

Until recently, the leading common law authority on the penalties doctrine was Dunlop. The essence of an unenforceable penalty clause was stipulation of a payment of money that was extravagant and unconscionable compared to the greatest loss that could conceivably be proved to have followed from the relevant breach, and not a genuine pre-estimate of the damage. This was to be assessed objectively, in the circumstances of each particular case, and as at the time of making the contract. This established the 'genuine pre-estimate of loss' test that would remain prevalent for the next century.

## **THE MODERN CAVENDISH SQUARE TEST: SECONDARY OBLIGATION / LEGITIMATE INTEREST**

The UK Supreme Court reviewed the law on penalties in Cavendish Square. The Court considered the penalty rule to be an "*ancient, haphazardly constructed edifice which has not weathered well*" and acknowledged that courts struggled to apply the Dunlop test to more complex cases.

The Court held (paragraph 32):

*The true test is whether the impugned provision is a secondary obligation that imposes 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.*

This means that the Cavendish Square test involves the following stages:

- Is the provision in question **secondary** in nature, i.e. only comes into operation in the event of breach of a primary obligation?
  - If not (i.e. the provision itself is primary in nature) then the penalties doctrine is not engaged.
- If so, the **legitimate interest** test applies:
  - First, what is the innocent party's legitimate interest in performance of the relevant primary obligation?
  - Second, is the consequence of breach out of all proportion to the legitimate interest?

In addition, the Court expressly acknowledged that a party's interest is in performance or some alternative to performance, and that this can extend beyond monetary compensation.

## UNCERTAINTY IN HONG KONG

The issue of penalties came before the Hong Kong Court of Appeal in *Brio Electronic Commerce Ltd v Tradelink Electronic Commerce Ltd*<sup>4</sup>, however, the Court did not consider the (then recently established) Cavendish Square test and whether it should replace the Dunlop test in Hong Kong. It was nevertheless largely expected that the Hong Kong courts would eventually adopt the Cavendish Square test.

In the following years, the Cavendish Square test was referred to several times by first instance courts, but the opportunity did not arise for the Court of Appeal to reconsider and expressly adopt the test until now.

## COURT OF APPEAL ADOPTS CAVENDISH SQUARE TEST

In *Law Ting Pong*, the penalties issue arose in the context of a teacher's employment and the 'Conditions for Service' providing for a three-month notice period or payment in lieu of notice. When the defendant wrote to the school to 'back out' of the contract, the school applied to the Labour Tribunal seeking to recover payment in lieu of the notice period. One of the defences raised by the defendant was that the relevant provision was unenforceable as a penalty.

The case progressed from the Labour Tribunal to the Court of Appeal, which took the opportunity to clarify whether the Dunlop genuine pre-estimate of loss or Cavendish Square legitimate interest test should apply.

The Court applied the Cavendish Square test and held that:

- (1) The provision is not secondary in nature, but rather is a primary obligation. The mechanism for payment in lieu of notice is a contractually-agreed and lawful method of termination of the employment contract. It is not in the nature of damages for breach. The doctrine of penalties is therefore not engaged.
- (2) Even if the doctrine is engaged, it does satisfy the 'legitimate interest' test.
  - a. The school's legitimate interest in enforcing the teacher's performance of the employment contract includes the importance of having suitable, steady and sufficient teaching staff at all times to address students' learning needs.
  - b. The payment in lieu of notice provided for is not out of all proportion to this interest, and the Court also noted that it is reciprocal in nature. The Hon Lam VP, in a separate but concurring judgment, also commented that a three-month period is common in employment contracts and cannot be said to be extravagant.

The Court also emphasised that the test must be applied in light of the circumstances at the time of formation of the contract, and not after termination. The defendant's focus on the school's actual monetary loss was misplaced.

Accordingly, the Court found the provision enforceable and restored the award of the Labour Tribunal for the defendant to pay damages in lieu of notice.

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<sup>4</sup> [2016] 2 HKLRD 1449

## **APPLICATION TO COMMERCIAL CONTRACTS**

The issue of penalties typically arises in the context of liquidated damages provisions. These are clearly secondary in nature as they are payable upon breach of a primary obligation, and so their enforceability turns on the 'legitimate interest' stage of the test.

However, various other mechanisms frequently included in transaction documents may also trigger the doctrine. For example, default interest under loan agreements (sometimes alarmingly referred to as 'penalty interest', although a court will look to substance over a label); termination payments and indemnities; break fees in M&A agreements; call options at a discounted price; and rights upon default such as withholding deferred consideration.

Properly formulated as contractually agreed and lawful methods of termination, some of these mechanisms may be considered as 'primary' obligations under the Cavendish Square test and the penalties doctrine is not engaged at all. In addition, the mechanism will not be considered a penalty if it proportionately protects legitimate interests such as the need for commercial certainty in volatile markets, avoiding damage to reputation or goodwill, or illiquidity in the market making it difficult to do a replacement deal.

## **CONCLUSION**

Application of the Cavendish Square test is more likely to result in a court or tribunal upholding a provision that has been negotiated at arm's length between commercially sophisticated and professionally advised parties than application of the Dunlop test. Importantly, it better distinguishes between primary obligations such as contractual exit mechanisms and secondary obligations such as liquidated damages, and the concept of a party's legitimate interests can take into account broader commercial factors. In contrast, parties subject to the Dunlop test may struggle to quantify and pre-estimate their loss in the context of complex transactions. This confirmation that Hong Kong law adopts the Cavendish Square test will therefore be welcome news to commercial parties.

## SUMMARY OF THE POSITION ON PENALTIES IN MAJOR COMMON LAW JURISDICTIONS

	<b>Singapore</b>	<b>UK</b>	<b>Australia</b>	<b>Hong Kong</b>
When the Penalty Rule applies	Only to secondary obligations i.e. when the clause is triggered by a breach of contract.	Only to secondary obligations i.e. when the clause is triggered by a breach of contract.	Applies even to clauses that are not triggered by a breach of contract.	Only to secondary obligations i.e. when the clause is triggered by a breach of contract.
Test to determine whether a clause is an unenforceable penalty clause	Whether the liquidated damages stipulated for are a genuine pre-estimate of loss. Dunlop test affirmed.	Whether the impugned provision constitutes a secondary obligation that imposes a detriment on the contract-breaker that is out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. Test in Cavendish applies.	No clear single test. However, the inquiry can proceed along the following lines: whether the sum or remedy stipulated is (1) exorbitant or unconscionable; (2) out of all proportion to the interests of the party which it is the purpose of the provision to protect; or (3) whether the stipulated is properly characterised as having no purpose other than to punish.	Whether the impugned provision constitutes a secondary obligation that imposes a detriment on the contract-breaker that is out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. Test in Cavendish applies.

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