

**Case Law Update -
Interpretation of terms in construction sub-contracts**

Speaker: Solomon Lam *Barrister-at-Law & Chartered Engineer*

Date: 19th August 2014

Solomon Lam

Barrister-at-Law, Chartered Engineer, HKIAC and HKMAAL Accredited Mediator, HKIAC List of Arbitrators

FHKI Arb, MCI Arb, MICE, CEng, MA ArbDR, BEng (CIV)

- **Worked in engineering consulting firm, contractor, claims consulting firm and MTRC**
- **Contributing editor of 'Hong Kong Construction Law' (Lexis Nexis)**
- **Now specializes in construction law and arbitration**

Questions

- 1. Do Hong Kong Courts interpret construction contracts differently?**
- 2. Do Hong Kong Courts recognize common sub-contract payment terms such as back-to-back or pay-when-paid?**
- 3. Any difference between the interpretation of construction main contracts and construction sub-contracts?**

General principles in interpretation of contracts

- **Objective meaning**
- **Assumed contract to be a consistent documents**
- **Contract to be read as a whole**
- **Ordinary and natural meaning**
- **Contra Proferentem rule**

Hong Kong Cases Update

1. *Tim Lee Construction Engineering Co. Ltd v Kwong Wah trading as Super King Engineering Co.* (HCCT 18/2000, 20 April 2012), before Mr. Recorder A Ho, SC

[Appeal dismissed in CACV 120/2012, 19 March 2013]

2. *Kim Hung Construction & Engineering Co. Limited v Standard Refrigeration & Engineering Co. Limited* (HCCT 37/2012, 21st June 2013 and 11st June 2014)

Tim Lee v Kwong Wah – Background Facts

- The defendant was the sub-contractor under a maintenance works subcontract for two shopping centres managed by The Link.
- The plaintiff was engaged by the defendant as the sub-sub-contractor responsible for certain maintenance and renovation works.
- Instructions for works were given by The Link by way of works orders, which were passed down from the main contractor to the defendant and on to the plaintiff. Thus the works orders became the instructions for works to the relevant sub-contracts. The scope of works was set out in general terms and only estimated value of works was given.

Tim Lee v Kwong Wah – Issues

- Issue 1 – how to interpret the term “back-to-back payment”
- Issue 2 - whether the plaintiff sub-sub-contractor is entitled to claim loss of profits?

Tim Lee v Kwong Wah – Issue 1

-The parties discussed that 'back-to-back payment' would be arranged

'for the supply/installation of work in a back to back payment basis'

-The plaintiff argued that this term referred to 'the time of payment' (and that there was also an implied term to pay upon completion of works or within 1 month). Therefore, the plaintiff's entitlement to payment was NOT conditional upon the defendant's receipt of payment from the main contractor.

(Note: the parties did not suggest that there was any particular meaning commonly understood in the trade for the clause 'back-to-back payment')

Tim Lee v Kwong Wah – Issue 1

Held:-

- It was a matter of construction on the expression
- The Court was to ascertain, objectively, what the parties had meant by the use of that expression in the circumstances of the agreement
- Subjective understanding of the expression 'back-to-back' irrelevant
- The factual background gave no indication that the defendant had accepted the risk by assuming an independent obligation to pay the plaintiff
- The natural meaning of the expression implied that the plaintiff would be paid when the defendant had received payment from its superior contractor for the relevant works
- Wording of contracts to be considered separately in each case

Tim Lee v Kwong Wah – Issue 1

Authorities followed:-

-Massford (HK) Limited v Wah Seng General Contractors Ltd (CACV 78/2005)

'Terms of Payment are on a back to back basis i.e.....your payment is subject to Architect's Payment Certificate.....'

Keating on Construction Contracts, 8th edition, para 12-057

Authorities distinguished:-

-Wo Hing Engineering Ltd v Pekko Engineers Ltd (HCA 5561/1996)

'This contract is based on back to back basis including payment terms'

-Smith & Smith Glass Ltd v Winstone Architectural Cladding Systems Ltd [1992] 2 NZLR 473

Tim Lee v Kwong Wah – Issue 2

- The values of the works orders were reduced from the estimated values of \$2.5M, \$4.5M and \$2.8M to \$560k, \$250k and \$225k.
- The plaintiff complained that such withdrawal or reduction in the scope of works had deprived it of the opportunity to complete the works and claimed for loss of profits.

(Note: the parties agreed that there was an implied term that the defendant would not hinder or prevent the plaintiff, either directly or indirectly, from carrying out its obligations under the sub-sub-contract)

Tim Lee v Kwong Wah – Issue 2

Held:-

- Absent an appropriate term to the contrary, once the work was instructed the contractor was entitled to complete the same and earn the profits if the works are in fact profitable
- However, since works orders contained only a general description of the works involved and details of the works would be supplemented by further instructions, the defendant was considered not having warranted that the works to be carried out would necessarily be of the stated value
- Solely comparing the estimated values of the works orders and those in the actual instructions was not considered to be a satisfactory basis of establishing the extent of the works withdrawn
- Furthermore, using financial statement to prove rate of profit at 7% was not accepted.

Kim Hung v Standard - Background

- Kim Hung's appeal against an arbitration award
- Hospital Authority (“HA”) to improve the ventilation systems in various public hospitals after the outbreak of SARS in Hong Kong in 2003.
- On or about 7 December 2005, Kim Hung (the Main Contractor) entered into a contract with HA (the Employer) to undertake construction works for the improvement of infection control provisions for autopsy facilities in 11 public hospitals. One of the construction works was the upgrading of the Mechanical Ventilation Air-Conditioning System which was sub-contracted to Standard (the Sub-Contractor). also commenced arbitration proceedings against HA on 9 September 2010.

Kim Hung v Standard - Background

The sub-contract between Kim Hung and Standard (“the Sub-Contract”) was based on the Hong Kong Construction Association’s Standard Form of Domestic Sub-contract 1994 Edition (“SFDSC”) as supplemented and modified by Standard’s letter dated 3 April 2006 and Kim Hung’s subsequent letter also of the same date. By this subsequent letter of Kim Hung, the terms and conditions of the main contract between HA and Kim Hung (“the Main Contract”), i.e. the Hong Kong Standard Form of Building Contract with the General Conditions amended by para 7.03 of the Specification Preliminaries (“SP”), were applied to the Sub-Contract on a “back-to-back” basis.

Kim Hung v Standard – the Arbitration

-Disputes subsequently arose between HA, Kim Hung and Standard. Standard commenced arbitration proceedings against Kim Hung on 22 July 2010 (“the Arbitration”), and Kim Hung also commenced arbitration proceedings against HA on 9 September 2010.

-One of the claim against Kim Hung was additional expenditure for the delay in giving possession of site

-The arbitrator found Kim Hung is liable to Standard for the Delay Claim in the sum of \$1,143,144.06 together with interest thereon.

Kim Hung v Standard – Grounds of Appeal

Kim Hung appeals the arbitrator's award on the Delay Claim on 2 major grounds:-

1. there was no contractual delay (delay issue)
2. payment was on a 'back-to-back' basis (payment issue)

Payment Issue - Relevant Contract Terms

SP6.02 “The Main Contractor shall be given sectional possession of the Site in groups as stated in the Appendix to the General Conditions of Contract and shall return these groups to the Employer on or before the relevant Date for Handover as stated below or a date which may be notified by the Architect in writing, whichever is the later: [a table]

The Main Contractor shall note that the possession dates given above are tentative dates only and the Main Contractor is deemed to have allowed in his tender for all extra costs and expense that may be incurred due to early or delayed possession of any of the Site and the Main Contractor shall not be entitled to claim any extension of time or loss and expense in the event that the actual dates are different from the above.

For the avoidance of doubt, the Time for Completion of the Works shall be calculated from the first date of possession of the Areas outside Mortuary.

The actual possession dates for each Section will be notified in writing by the Architect.”

Payment Issue - Relevant Contract Terms

SP 7.02 – the dates for site possession of all Section 1 to 3 Hospitals are to be notified by the Architect

Clause 10.2 of Standard Form of Domestic Sub-Contract – *'The Sub-Contractor shall have equivalent rights to payment for complying with or as a consequence of an instruction of the Employer's Representatives or other event as the Contractor has under the Main Contract.'*

SCC 11(4) "If upon written application having been made by the Main Contractor to the Quantity Surveyor, the Quantity Surveyor is of the opinion that the Main Contractor has been involved in additional expenditure by reason of the progress of the Works or any part thereof having been materially affected by the failure of the Employer to give possession in accordance with this Clause then the Quantity Surveyor shall ascertain the cost incurred and shall certify in accordance with Clause 30 of these Conditions."

Standard's Arguments

- Kim Hung is entitled to claim additional expenditure when the Employer had delay in giving possession sites according to SCC 11(4)
- Relying on Clause 10.2 of Standard Form of Domestic Sub-Contract, Standard has the same right for payment

Kim Hung's Arguments

- the dates stated under the Main Contract and the Sub-Contract were tentative only, the actual dates for possession had to be notified by the Architect
- SP6.02 states that the Contractor had to make allowance for any delay in gaining possession of the sites without any claim for compensation
- SCC 11(4) would only be applicable if the Employer did not give possession of the sites to the Main Contractor or the Sub-contractor **ONLY AFTER** the architect had issued the notifications of possession of sites

Arbitrator's decision

- SP6.02 and SCC 11(4) were in conflict
- SCC 11(4) was a supplementary provision therefore prevailed over SP 6.02 as a general provision
- Kim Hung was entitled to claim payment under SCC 11(4)
- According to Clause 10.2 of Standard Form of Domestic Sub-Contract, Standard should have the equivalent right to claim Kim Hung
- Kim Hung had maintained that there was a cause of action against the HA all along and this amounted to admission that HA had been in delay in giving possession of sites

Court's Decision

- The Court found that there was **no conflict** on SP6.02 and SCC 11(4).
- SCC 11(4) governs the scenario if the Employer did not give possession of the hospital sites to the Main Contractor after notification issued by the Architect, then the Main Contractor is entitled to lodge a delay claim against the Employer

Court's Decision

SP6.02 means that:-

1. the dates of possession of the sites of the 11 hospitals were all tentative dates only;
2. by the tentative nature of the dates of possession, the Main Contractor was deemed to have allowed in his tender for all extra costs and expenses that might be incurred due to early or delayed possession of any of the sites and the Main Contractor shall not be entitled to claim any extension of time or loss and expenses in the event that the actual dates were different from the tentative dates; and
3. the actual possession dates for each Section would be notified in writing by the Architect.

Court's Decision

- Therefore, the Court concluded that the dates of possession stated in SP 6.02 were all tentative dates only.
- The contractor had to make allowance in his tender for all extra costs and expenses that might be incurred due to early or delayed possession of any of the sites and the contractor shall not be entitled to claim any loss or expenses in the event that the actual dates were different from the tentative dates

Court's Decision

- Since under Clause 10.3 of Standard Form of Domestic Sub-Contract, Kim Hung has a duty to submit the delay claim to the HA on behalf of Standard. Therefore, Kim Hung had to make an assertion that the delay claim was a valid one
- The arbitrator was wrong in relying on the 'admissions' of Kim Hung

Court's Decision

-The Court also found (against Standard) that:

1. whether the Architect had issued notifications for possession was not an issue raised in the arbitration
2. commercial fairness was not to be considered
3. Contra proferentum rule was not applicable since there was no ambiguity

Court's Decision

- The arbitrator's finding that there was actionable delay based on interpretation of contract was clearly wrong
- The Court allowed the appeal and set aside the Interim Award of the arbitrator in relation to the Delay Claim

[The judge remarked that if he was wrong, the payment issue would be relevant and therefore continued to discuss this issue in the judgment]

Payment Issue

- Kim Hung appeals the arbitrator's award on the 2nd ground that payment was on a 'back-to-back' basis
- What is the consequence if the sub-contract payment term is on a 'back-to-back' basis?
- What are Kim Hung's arguments?
- What are Standard's arguments?

Payment Issue – Relevant Contract Terms

1. Clauses 1 and 2 of the letter of acceptance – apply all terms of the Main Contract to the Sub-Contract on a back-to-back basis
2. Under SCC 11(4), 11(6) and SCC 4 of the Main Contract, all variations required by the Architect and the direct loss and expenses thereof shall be measured, valued and ascertained by the QS

Payment Issue – Relevant Contract Terms

3. Clause 10.3 of Standard Form of Domestic Sub-Contract:

“Subject to the Sub-Contractor complying with Clause 10.1, the Contractor shall take all reasonable steps to secure from the Employer such contractual benefits, if any, as may be claimable in accordance with the Main Contract for any circumstances that may affect the execution of the Sub-Contract Works and the Sub-Contractor shall in sufficient time afford the Contractor all information and assistance that may be requisite to enable the Contractor to claim such benefits. On receiving any such contractual benefits from the Employer, the Contractor shall within fourteen (14) days of receipt of such benefits, in turn pass on to the Sub-Contractor such proportion thereof as may in all the circumstances be fair and reasonable, subject to any deductions allowable under the provisions of the Sub-Contract. Upon written request, the Contractor shall supply the Sub-Contractor with a copy of any valuation of additional payment due to delay and/or disruption received from the Employer or his consultants in respect of the Sub-Contract Works.....”

Payment Issue – Relevant Contract Terms

3. Clause 10.3 of Standard Form of Domestic Sub-Contract:

“..... Save as aforesaid, the Contractor shall have no liability to the Sub-Contractor in respect of any condition, obstruction or circumstance that may affect the execution of the Sub-Contract Works and the Sub-Contractor shall be deemed to have satisfied himself as to the correctness and sufficiency of the Sub-Contract Price to cover the provision and doing of all things necessary for the performance of his obligations under the Sub-Contract.

Provided always, that nothing in this Clause shall prevent the Sub-Contractor from claiming extensions of time and/or damage, loss and expense for delays in the execution of the Sub-Contract Works caused by the act or default of the Contractor.”

Payment Issue – Relevant Contract Terms

4. Clause 15 of Standard Form of Domestic Sub-Contract:

“15.5 Within forty-nine (49) days of the Specified Date or otherwise as agreed but subject as hereinafter provided, there shall be due to the Sub-Contractor in respect of the value of the work and materials if included in a valid statement payment of a sum calculated in accordance with the rates and prices specified in this Sub-Contract, or by reference to the Sub-Contract Price, as the case may require, but subject to a deduction of previous payments and of retention monies at the rate(s) specified in the Third Schedule hereto until such time as the limit of retention (if any) therein specified has been reached.”

Payment Issue – Relevant Contract Terms

4. Clause 15 of Standard Form of Domestic Sub-Contract:

“15.6(a) Subject to Clauses 3.4, 10.4 and 17.3 and as hereinafter provided and without prejudice to any rights which exist at Common Law, the Contractor shall be entitled to withhold or defer payment of all or part of any sums otherwise due pursuant to the provisions hereof where :-

... ..

(iii) the amounts or quantities included in any valid statement are not certified in full by the Employer’s Representatives, providing such failure to certify is not due to the act or default of the Contractor;

(iv) the Contractor has included the amounts or quantities set out in the valid statement in his own statement in accordance with the Main Contract and the Employer’s Representatives have certified but the Employer has failed to make payment in full to the Contractor in respect of such amounts or quantities, or

(v) a dispute arises or has arisen between the Sub-Contractor and the Contractor and/or the Contractor and the Employer involving any question of measurement or quantities or any matter included in any such valid statement.”

Payment Issue – Relevant Contract Terms

4. Clause 15 of Standard Form of Domestic Sub-Contract:

“15.6(b) Any payment withheld under the provisions of Sub-Clauses (a)(iii), (iv) or (v) above shall be limited to the extent that the amounts in any valid statement are not certified, not paid by the Employer or are the subject of a dispute as the case may be.

(c) In the event of the Contractor withholding any payment, he shall notify the Sub-Contractor of his reasons in writing as soon as is reasonably practicable but not later than the date when such payment would otherwise have been payable.

(d) The provisions of this Clause with regard to the time for payment shall not apply to the amounts or quantities in any valid statement by the Sub-Contractor which are included in the Contractor’s statement of final account to the Employer under the provisions of the Main Contract. In respect of any such amounts or quantities, payment shall be due seven (7) days after receipt by the Contractor of any payment which includes a sum in respect of such amounts or quantities.”

Payment Issue – Relevant Contract Terms

4. Clause 15 of Standard Form of Domestic Sub-Contract:

“15.7(a) Within forty-nine (49) days of the issue by the Employer’s Representatives of a certificate including an amount in respect of payment to the Contractor of the first half of the retention monies or where the Main Works are to be completed by sections for any section in which the Sub-Contract Works are comprised, the Contractor shall pay to the Sub-Contractor the first half of the retention monies under this Sub-Contract.

(b) Within seven (7) days of the Contractor’s receipt of any payment under the Main Contract which is by way of release of the second half of the retention monies, the Contractor shall pay the Sub-Contractor the second half of the retention monies under this Sub-Contract.”

Payment Issue – Relevant Contract Terms

4. Clause 15 of Standard Form of Domestic Sub-Contract:

“15.8 Within three (3) months after the Sub-Contractor has finally performed his obligation under Clause 13 (Maintenance and Defects), or within fourteen (14) days after the Contractor has recovered full payment under the Main Contract in respect of the Sub-Contract Works, whichever is the sooner and provided that one (1) month has expired since the submission by the Sub-Contractor of his valid statement of final account to the Contractor, the Contractor shall pay to the Sub-Contractor and the Sub-Contract Price and/or any other sums that may have become due under the Sub-Contract, less such sums as have already been received by the Sub-Contractor on account.”

Arbitrator's Decision

- The arbitrator found that payment to Standard was not on a 'pay-when-paid basis', the Arbitrator relied on the terms in Clause 15.8 of Standard Form of Domestic Sub-Contract that Standard should be paid by Kim Hung if either of these two conditions were satisfied:-

(1) Standard had finally performed the obligation which is sooner than Kim Hung has received payment

(2) 1 month had expired since the submission of valid statement of final account.

- The arbitrator found Kim Hung had failed to take reasonable steps to secure the contractual benefit for Standard and Kim Hung should be liable for additional expenses incurred by Standard in respect of the delay in possession of sites

Court's Interpretation on Standard Form of Domestic Sub-Contract

- Clause 15 refers to a valid statement by the sub-contractor setting out the value of the work properly done under the sub-contract and of all material delivered to the site for incorporation in the sub-contract works. The main contractor would then submit the valid statement to the employer for payment
- Clause 15.5 actually provides for the due date for the payment of the value of work and materials if included in a “valid statement”, which is 49 days after the Specified Date as defined.
- Clause 15.6(a) provides that the Main Contractor is entitled to withhold payment under certain circumstances, and it is common ground that those circumstances are applicable in the present case (i.e. the Delay Claim has not been certified by the Architect, Kim Hung has not received the payment for the Delay Claim and there is a dispute between the Employer and Kim Hung relating to the Delay Claim).

Court's Interpretation on Standard Form of Domestic Sub-Contract

- Clause 15.6(d) specifically provides that the amounts or quantities in any valid statement by the Sub-Contractor which had been included in the Main Contractor's "statement of final account" to the Employer would only be due 7 days after receipt by the Main Contractor of any payment which included a sum in respect of such amounts or quantities. Under such circumstances, the payment for the Delay Claim simply has not been due for payment under the Sub-Contract
- Clause 15.8 deals with the specific scenario that the sub-contractor has completed all the works under the sub-contract and submitted the valid statements of final account to the main contractor

Court's Decision

- The Court considered the main point was whether the payment under the Delay Claim was a sum due under the Sub-Contract under Clause 15.8
- However, SCC 11(4) provided that the payment to be certified by the Architect
- As the terms of the Main Contract were applied to the Sub-Contract on a back-to-back basis, the Delay Claim has not yet been due
- So Standard could not ask Kim Hung for payment under Clause 15.8

Court's View on Delay Claim Procedures

- The payment term for a delay claim was that it required the certification of the Architect
- If Standard seeks to make a delay claim under SCC 11(4), it first has to submit such a claim to Kim Hung
- Kim Hung then has a duty to claim against the HA under Clause 10.3 of Standard Form of Domestic Sub Contracts by reviewing the decision of the Architect
- If the arbitrator disagrees with the Architect and allows the delay claim, the HA has the obligation to pay Kim Hung
- Kim Hung then has to pay Standard

Further Observations by the Court

- pay-when-paid and Kim Hung taking reasonable steps to secure contractual benefit for Standard are 2 distinct issues
- if the contract was not on a pay-when-paid basis, then there was no obligation for Kim Hung to take reasonable steps
- these 2 are mutually exclusive
- the arbitrator had mixed them up

2nd Judgment on 11th June 2014

- The Court stated further that the arbitrator found that Kim Hung had breached Clause 10.3 in failing to take reasonable steps was a finding of fact
- However, whether Kim Hung was in breach of Clause 10.3 was a non-issue

Observations from these recent Court cases

- The interpretation of construction contracts follow the same rules as other commercial contracts
- Courts accept 'back-to-back' payment terms
- Contra proferentum is not the golden rule

Q: How about interpretation of construction contracts in the next arbitration?

Q & A