



Essential Principles in Breach of Contract

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Seminar Outline

1. Conditions, innominate terms, warranties;
2. Repudiatory breach;
3. Anticipatory breach;
4. The award of damages;
5. Foreseeability of damages;
6. Mitigation of damages;
7. Liquidated damages and penalty;
8. Specific performance;
9. Injunction;
10. Limitation period.

Introduction: Breach of contract

- A breach of contract occurs where a party to a contract repudiates or fails to perform the contractual obligations.
- It may occur where a party fails to perform its obligation by the time fixed for performance by the contract.
- A breach may occur when one party indicates that it will not perform its promises. This gives rise to the repudiation of the contract.
- There may be a breach if a party does some act which disables it from performing its obligation. For example, the employer appoints another contractor to carry on with the work. This may be referred to as anticipatory breach where a party is rendered liable for a breach of a promise binding at present.

Introduction: effect of breach

- A breach of contract entitles the innocent party to claim for damages. Yet, it does not always discharge the innocent party from further performance.
- Any breach of contract gives rise to a cause of action; not every breach gives a discharge from liability.
- *Mersey Steel & Iron Co v Naylor Benzon & Co.* (1884) 9 AC 434 at 438, HL :
- The buyer, acting upon erroneous legal advice, refused to pay unless the seller, who faced with a winding up petition, obtained court permission for payment. Held, the conduct of the buyer did not amount to repudiation.
- ...you must look at the actual circumstances of the case in order to see whether one party to the contract is relieved from its future performance by the conduct of the other; you must examine what that conduct is, so as to see whether it amounts to renunciation, to an absolute refusal to perform the contract, such as would amount to a rescission if he had the power to rescind, and whether the other party may accept it as a reason for not performing his part...
- In my judgment, they have not in any portion of the proceeding acted so as to shew an intention to renounce or to repudiate the contract, or to fail in its performance on their part.

1. Conditions, innominate terms, warranties

- Where a term of the contract, essential to the continued existence of the contractual ties, is broken, this breach destroys the foundation of the contract.
- Previously, contractual terms are either classified as “conditions” or “warranties”.
- The breach of “conditions” would entitle the innocent party to refuse further performance.
- A term may be classified as a condition if there are precedent decisions or legislation so categorizing it, or when the parties have so agreed in the contract.
- The fact that a commercial contract described one of its terms as a condition did not compel the court to hold that that term was a condition in the strict sense and that the question would be decided by construing the contract as a whole: *L Schuler AG v Wickman Machine Tool Sales Ltd* [1974] AC 235.

1. Conditions, innominate terms, warranties

- The breach of “warranties” merely gave rise to a right to damages.
- Intermediate term is a contractual term, which could be breached in a trivial way or a fundamental way: See *City Famous Ltd v Profile Property Ltd* [1999] 3 HKLRD 15.
- *HongKong Fir Shipping v Kawasakin Kisen Kaisha Ltd* [1962] 2 QB 26 at 71, HL.
- ...the shipowner’s undertaking to tender a seaworthy ship, as a result of numerous decision as to what can amount to “unseaworthiness,” become one of the most complex of contractual undertakings.
- It embraces obligations with respect to every part of the hull and machinery, stores and equipment and the crew itself. It can be broken by the presence of trivial defects easily and rapidly remediable as well as by defects which must inevitably result in a total loss of the vessel.
- It is like so many other contractual terms an undertaking one breach of which may give rise to an event which relieves the charterer of further performance of his undertakings if he so elects and another breach of which may not give rise to such event but entitle him only to monetary compensation in the form of damages.

2. Repudiatory breach

- As held in *Hongkong Fir Shipping*, the test whether an event discharges one of the parties from further performance of his undertakings is this: does the occurrence of the event deprive the party who has further undertakings still to perform, of substantially the whole benefit, which it was the intention of the parties as expressed in the contract that he or she should obtain as the consideration for performing those undertakings.
- One must look at the actual circumstances of the case in order to see whether the one party to the contract is relieved from its future performance by the conduct of the other.
- What must be examined is whether that conduct amounts to an absolute refusal to perform the contract, such as would amount to repudiation.

2. Repudiatory breach

- *Decro-Wall International SA v Practitioners in Marketing* [1971] 1 WLR 361 at 368, CA
- The defendant delayed payments between 2 and 20 days. The reason was the defendants' shortage of working capital. However, the plaintiffs never doubted the defendants' ability to pay.
- A breach of contract may be of such a nature as to amount to repudiation and give the innocent party the right (if he desires to exercise it) to be relieved from any further performance of the contract, or the breach may entitle the innocent party only to damages.
- How is the legal consequence of a breach to be ascertained? Primarily from the terms of the contract itself. The contract may state expressly or by necessary implication that the breach of one of its terms will go to the root of the contract and accordingly amount to repudiation.
- Where it does not do so, the courts must look at the practical results of the breach in order to decide whether or not it does go to the root of the contract

2. Repudiatory breach

- The breach of contract must go to the root of that contract for there to be a repudiation.
- A deliberate refusal to make an interim payment is capable of amounting to a repudiation of the contract.
- The non-payment of an instalment of the price may normally be treated as a repudiatory act.
- A party is not entitled to insist that it is not repudiating because it proposes to perform part of the contract in a manner not permitted by the contract.
- Ultimately one has to examine the facts of the case to see whether the non-payment amounted to repudiation.
- The principle is to consider whether the circumstances of the non-payment show an intention not to be bound.

2. Repudiatory breach

- In the context of the construction projects, a distinction between a breach that discharges the innocent party from performance and one that merely entitles it to claim damages is of crucial impact.
- *Canaterbury Pipelines v Christchurch Drainage* (1979) 16 BLR 76. The New Zealand Court of Appeal that there was no power to suspend work for non-payment at common law.
- *Creatiles Building Materials Co Ltd v To's Universe Construction Co Ltd* [2003] 2 HKLRD 309. Hong Kong Court of Appeal confirmed that there was no general right in common law to suspend work if payment was wrongly withheld and observed that a deliberate refusal to make an interim payment was capable of amounting to a repudiation of the contract.
- Held, there was repudiation by the contractor who refused to pay the sub-contractor.
- Dispute between specialist subcontractor and contractor. Contractor only paid part of the sum invoiced by the subcontractor and delayed another sum for 2 months.

2. Repudiatory breach

- *Hongkong Underground Engineering Ltd v Welcome Construction Co Ltd* [2005] HKEC 1264
- Sakhani J held that the ‘potency’ and legal effect of the concerned breach was to be judged in the light of the seriousness of the breach and its effect upon the continuing performance of the contract and this involved an examination of the circumstances of the breach itself as well as its implications for the future of the contract and any likelihood of repetition.
- In finding that the contractor did evince an intention not to be bound by the contract, it was also stressed, in doing so objectively, the court could only concern itself with the reasonable perceptions and reactions of the party asserting a repudiatory breach and it would not take into account concerns or fears, which, however naturally entertained, were not justifiably grounded in the actions and intentions manifested by the party alleged to be in repudiatory breach.

3. Anticipatory breach

- Where a party expresses its intention not to perform its contractual obligation before its performance is due, or acts in such a way as to show its intention to break the contract before performance is due, the party has committed an “anticipatory breach” of the contract.
- In such circumstances, the innocent party has 2 options:
 - 1. He may accept the breach and immediately sue for damages;
 - 2. He may ignore the breach and wait for the time when the performance is due. In that case, the contract continues to bind both parties and the defendant will commit a breach only if the defendant fails to perform the contractual obligation on the due date.
- If the guilty party does not perform the contract by then, the innocent party may sue for an appropriate remedy, damages or specific performance.
- In the case of sale or disposition of an interest in land where specific performance is available, the innocent party may elect between damages or specific performance.

3. Anticipatory breach

- Keating, 8th ed, at p. 208, paragraph 6-067:
- If the innocent party does not elect to accept the repudiation but affirms the contract, the defaulting party may continue to rely on the terms of the contract, including any agreed damages or cancellation clause, unless on its true construction any term excluding or limiting his liability was not intended to cover the kind of breach which has been committed.
- There is a middle ground between acceptance of repudiation and affirmation of the contract during the period when the innocent party is making up his mind what to do.
- If he does nothing for too long, there may come a time when the law will treat him as having affirmed.
- If he maintains the contract in being for the moment, while reserving his right to treat it as repudiated if the other contracting party persists in his repudiation, then he has not yet elected...

4. The award of damages

- *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827:
- Every failure to perform a primary obligation is a breach of contract.
- The secondary obligation on the part of the contract-breaker to which it gives rise by implication of the common law is to pay monetary compensation to the other party for the loss sustained by him in consequence of the breach.
- Thus, the nature of damages is compensatory.
- The general principle is that the innocent party is to be placed, as far as money can do, in the same position as if the contract had been performed.
- The time for assessment of loss is at the time of the breach.

4. The award of damages

- Another possible way of calculating damages is by way of cost of repair.
- In *Ruxley Electronics and Construction Ltd v Forsyth* [1996] AC 344, HL, a swimming pool of only 6 feet deep was built. The contract specified a diving area of 7 feet 6 inches deep. The court awarded general damages of £2,500 for loss of pleasure and amenity, not the cost of reinstatement.
- Held, that where the expenditure was out of all proportion to the benefit to be obtained the appropriate measure of damages was not the cost of reinstatement, but the diminution in the value of the work occasioned by the breach, even if that would result in a nominal award.
- Generally speaking, no damages are allowed for any distress, frustration, anxiety, displeasure, vexation, tension or aggravation to the innocent party resulting from a breach of contract.
- *Farley v Skinner* [2001] 3 WLR 899, damages can be awarded where a major or important object of the contract is to provide pleasure, relaxation or peace of mind.

5. Remoteness of damages

- A leading two-limb test for assessing foreseeability of damage is provided in *Hadley v Baxendale* (1854) 9 Ex 341,
- Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either [1] arising naturally, ie according to the usual course of things from such breach of contract itself, or [2] such as may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract, as the probable result of the breach of it”.
- Thus, in gist, damages under the first limb are recoverable if they are likely to result; damages under the second limb are recoverable if there is additional or special knowledge.
- The ultimate criterion is the reasonable anticipation of the defendant, in light of the circumstances known to it at the time of contract: see *Victoria Laundry v Newman Industries* [1949] 2 KB 528.

5. Remoteness of damages

- When put to operation, the Hong Kong Court of Final Appeal observed in *Chen v Lord Energy Ltd* [2002] 1 HKLRD 205 that the demarcation between the two limbs of the rule in *Hadley v Baxendale* was sometimes blurred, particularly in the case where knowledge of a certain matter was imputed to the defaulting party, and that there might be an overlap between the first and second limb of the rule.
- Hence, it was held that it was unnecessary to categorize it as falling strictly within either limb of the rule.

6. Mitigation of damages

- Though there is a breach, the innocent party is still under a duty to mitigate its loss arising from the breach.
- This means that the innocent party is under a duty to take all reasonable steps to mitigate the loss consequent on the breach and debars it from claiming any part of damage that is due to its neglect to take such steps.
- Yet, this does not impose on the innocent party an obligation to take any step that a reasonable and prudent man would not ordinarily take in the course of his business.
- The party who suffers damage is only bound to act in the ordinary course of its business.
- The burden of proof is on the defaulting party to prove that the innocent party did not minimize its damage.

7. Liquidated damages

- Liquidated damages (LD) describes the monetary compensation paid to the employer by the main contractor in the event of late completion.
- Based on the principle that liquidated damages aim to provide compensation to the owner for financial and other losses resulting from delayed completion, this amount is commonly estimated as the daily rentable value of the property after taking into account likely occupancy rates.
- The essence of liquidated damages is a genuine pre-estimate of loss from the employer resulting from delayed completion.

7. Liquidated damages

- Benefit to the contractor – knowing in advance the financial liability in the event of late completion.
- Benefit to the employer – it does not have to prove the loss and there is a mechanism in the contract for deduction of the damages from monies due to the contractor.
- Liquidated damages represents a reasonable reflection of the anticipated costs incurred by the owner for late project completion.
- See Clause 52, *General Conditions of Contract for Building Works*, 1999 Edition.

7. Penalty

- A penalty is assumed to exist when the sum is sufficiently above the anticipated costs of late completion so as to constitute a punitive measure.
- Penalty provisions are generally not enforceable.
- It is in truth of the nature of a treat *in terrorem*, i.e. acting as a mere security to the promise that the contract will be performed.

8. Specific performance

- An order for specific performance is a court order compelling actual performance of an obligation under the contract.
- Breach of such an order may be visited by a prison sentence or monetary penalties for contempt of court.
- This is an equitable remedy and hence is subject to the discretion of the court.
- The court will normally not grant specific performance where the common law damages will adequately compensate the claimant, nor where the court cannot properly supervise performance

8. Specific performance

- The court will not normally compel the building of houses: *Wilkinson v Clements* [1998] AC 1;
- Damages may be granted in lieu of specific performance: *Johnson v Agnew* [1980] AC 367;
- Specific performance could be ordered in building work if the work is sufficiently defined by contract for the court to see its exact nature; there is a substantial interest, not adequately compensated by damages, in having the contract performed; and the land was in possession for work to be done: *Carpenters Estates Ltd v Davies* [1940] Ch 160.

9. Injunction

- An injunction is an equitable remedy ordering a person to do something, or restraining a person from doing a wrong.
- It is not common that an injunction would be granted between parties to civil engineering contracts.
- It is not uncommonly granted against a third party to prevent trespass or nuisance or contravention of legislation caused by building operation, particularly as an interim measure of protection.

9. Injunction

- The governing principles for grant of an injunction in the interim period ending trial: *American Cyanamid Co v Ethicon Ltd* [1975] AC 396
- Where there is a serious question to be tried and damages are not an adequate remedy, if the defendant is protected against the effect of an injunction by the plaintiff's undertaking as to damages, an injunction may be granted upon consideration of the balance of convenience.

9. Injunction

- *Yau Fook Hong Co Ltd v Man Cheong Construction Co* [1981] HKLR 60, where the employer sought an injunction to repossess the site following the termination of a building contract on the grounds of the contractor's delay in proceeding regularly and diligently with the work.
- The contractor contended that there was delay in payments by the employer and that the termination of the contract was on invalid grounds, amounting to a repudiation of the contract.
- Held, there was a serious question to be tried and it could not be said that the employer had no real prospect of success for a permanent injunction, an interlocutory injunction was granted restraining the contract from remaining on site.

10. Limitation period

- A right for remedy for breach of contract may be extinguished by lapse of time under the Limitation Ordinance (Cap 347).
- Section 4 of the Limitation Ordinance (Cap 347) provides that actions founded on simple contract, ie a contract not under seal, shall not be brought after the expiration of 6 years from the date on which the cause of action accrued, and an action upon a contract under seal cannot be brought after the expiration of 12 years from the accrual of the cause of action.

10. Limitation period

- The statutory period begins to run when a breach of contract is committed and the fact that actual damage is not suffered until some later date does not extend the time, as illustrated in *Howell v Young* (1826) 5 B&C 259.
- In general, subject to exceptional circumstances such as fraud, the mere fact that the breach of contract has not been discovered until after the expiration of the statutory period does not prevent extinction of the remedy.

10. Limitation period

- The importance of having a construction contract under seal lies in the fact that the cause of action for breach of contract is extended from 6 to 12 years. This will be relevant in relation to latent defects that do not surface until sometime after the construction works are completed.
- An illustration for the risks associated with latent defects in construction work is found in the case of *Bank of East Asia Ltd v Tsien Wui Marble Factory Ltd*[2000] 1 HKLRD 268, where the cause of action in contract had expired when the defects or their extent became apparent.



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Thank you