Without Prejudice Negotiations

There comes a point in time at the conclusion of every construction contract when the parties will seek to reach a mutually satisfactory agreement concerning all the aspects of the transaction that has taken place between them. In the field of construction contracts these negotiations will undoubtedly concern money but they may also encompass negotiations on other aspects of the transaction such as entitlement to extensions of time or perhaps matters concerning the quality of the as-built Works. Whatever the circumstances of the particular case, since it takes two to sign a contract, the settlement negotiations will involve both of the contracting parties and it is a fact of commercial contract life that each will be seeking to secure the best deal they can get.

As part of this negotiation process, the underlying policy in commercial contracts as far as the courts are concerned, is that both during settlement negotiations and in instances of where the negotiations lead to a dispute, the parties should be encouraged to settle that dispute privately without having to resort to litigation or arbitration, and should certainly not be discouraged by the knowledge that anything that is said in the course of their negotiations might be used to their prejudice in any subsequent legal or arbitration proceedings, should their attempts to negotiate an agreement ultimately fail.

The desire is that the parties should be able to express themselves freely in commercial settlement negotiations and should be able to speak frankly to one another without inhibition in the hope of ultimately reaching a settlement. Where a dispute does arise, and in order for the negotiations to make any meaningful inroads in resolving that dispute, the parties, by necessity, need to shift their respective positions as taken in open correspondence, more towards the middle ground. However, the last thing either party wants is for the settlement negotiations to break down and the other party then being in a position to better advance its own case or take advantage of what may be seen as a lack of merit in the other party’s case, and to be able to present those points to the judge or arbitrator.

A necessary part of any trial or arbitration proceeding is the disclosure of documents to provide each of the parties with the necessary documentary material to assist them in assessing the strengths and weaknesses of their respective cases. It is not difficult to imagine the adverse inferences that might be made to a party’s case if oral and written negotiation communications were also to form part of this collection of documentary material made available to the judge or arbitrator. For this reason, the law offers a measure of protection to both written and oral communications that are intended to reach a compromise, whereby a party may enter into negotiations with an opponent on a without prejudice basis.

Without Prejudice

The effect of the without prejudice provisions are that communications, whether oral or in writing, become privileged, that is they may not be disclosed to the court or arbitrator without the consent of both parties and will not be ordered to be disclosed in discovery. The without prejudice provisions may therefore be perceived as a very straight-forward form of protection and one that appears to automatically prevent the disclosure of certain communications, almost at the will of the writer, merely by using the label without prejudice. The reality however is not quite so straightforward.

The whole purpose of the without prejudice procedure is to enable a party to compromise its position during the negotiation phase in an attempt to reach a settlement, free from the fear that that compromise might come back to bite that same party at some later point in time. This being the case, the central feature of the without prejudice provision is that one of the parties, during the course of those negotiations, puts itself in a compromised position rather than the stance taken in open correspondence and/or meetings, i.e. a position which is less beneficial or more damaging to itself. An example might be a Contractor accepting a lesser amount of money than that claimed in it’s claim submissions, or an employer acknowledging an entitlement to a further extension of time award and consequently the Contractor having a reduced liability for Liquidated Damages. Written or oral communications which do not include this essential feature of pursuing a compromised position will not be privileged, even if the correspondence relating to that communication is headed without prejudice.

Since the phrase without prejudice is intended to prevent the writer from being prejudiced by the contents of a letter or document (or even something that is said orally), the phrase should only be used if that letter or document contains something that the writer does not want revealed openly in court or arbitration. It therefore follows that the phrase should only be used in certain instances and in relation to specific types of letters and or documents, and to use it on correspondence that a party may actually want to refer to during a trial or arbitration would clearly be self defeating. Similarly, if the writer’s intention is that certain correspondence is required to be private and confidential then it would be wrong to...
mark it without prejudice, since private and confidential is not the same thing as without prejudice. Further, to use the label in correspondence which merely restates the original claim but makes no attempt at a compromise would be pointless, since, firstly, no protection would be afforded to such a letter since the essential element of compromise is missing and secondly, it might even be perceived by the other party as a letter having legal connotations which might then invite a legal response and which may have the inadvertent result of somewhat souring the settlement negotiations. The use of the without prejudice label should therefore be used selectively.

To issue the without prejudice label too liberally might give rise to the unfortunate situation whereby a letter or document contains a mixture of both information that the writer wants protecting and information which would be useful to disclose during discovery. For example a Contractor’s letter or submission could contain both statements which might benefit that party’s case and statements which constitute genuine negotiation compromises. Whilst it might be possible to withdraw the without prejudice label on an entire letter or document, it might be very much more difficult to individually separate the without prejudice parts of a sentence or paragraph from the body of a letter, whilst hoping to retain the original meaning and context of the letter or document when read as a whole. The better method therefore is that if a letter or document involves a mixture of items, only some of which are for the purpose of achieving a negotiated settlement, then two letters or documents should be prepared instead of one, and with only one clearly marked without prejudice. This should ensure that the full force of the without prejudice protection is afforded to the settlement negotiation communications only.

**Marking Without Prejudice**

Contrary to popular belief, it is not absolutely necessary that every letter or document in a chain of settlement negotiations be marked without prejudice in order for them to secure the protection, for two reasons. Firstly, the courts have held that the principle of privilege can protect subsequent letters which are part of the same chain of correspondence, even in instances of where the without prejudice label has not been used in individual pieces of correspondence. So, if a Contractor’s letter which is not marked without prejudice provides further and better particulars to a Contractor’s submission which was previously marked without prejudice, and the letter forms part of the same chain, then it is likely that the letter would be protected. Secondly, it is the content of the letter or document that secures the protection and not merely it’s heading or title. A letter not marked without prejudice but which clearly forms part of a settlement negotiation would be protected even in the absence of the label without prejudice. Conversely a letter marked without prejudice would, in itself, provide no protection at all, since it is the content of the letter itself, and not it’s title, that must be for the purpose of settlement negotiations. The without prejudice label is merely a signpost that prepares the reader for what, in theory, lies within the body of the letter but it does not automatically follow that the letter is indeed part of genuine settlement negotiations. If the purpose of the letter is not to reach a compromise, then no protection will be afforded to the letter, irrespective of its title or label.

In the event of a dispute over whether a particular letter or document was indeed protected, a court or arbitrator would look at the character of the letter and possibly even the chain of correspondence that the letter forms part of as a whole, rather than simply the letter’s title.

The protection afforded to privileged letters and documents is particularly relevant during the discovery and inspection stage of court or arbitration proceedings, however it is important to realise that there is no class of documents that are exempt from discovery but privileged documents are exempt from inspection. The normal practice in such events is that without prejudice communications that do form part of negotiation correspondence are listed separately and are suitably grouped, in order that their individual identity as well as indications as to their content, are not revealed to the court or the arbitrator and thus the protection is achieved.

**Summary**

The without prejudice label is not an uncommon feature on correspondence and submissions in negotiations and with the increased use of Alternative Dispute Resolution methods now being used in attempting to genuinely resolve construction related disputes, the importance of privilege and the use of the without prejudice label is becoming even more important. Bearing in mind that many construction disputes are now being resolved through mediation, the concept of privilege might well apply to all the written and oral communications relating to the mediation in its attempt to genuinely bring the dispute to a resolution. Bearing in mind the above, the importance of denoting without prejudice on appropriate letters and documents for such a mediation or indeed for any negotiation communication should not be done without careful consideration.
have been asked a few times recently to provide advice on how a quantity surveyor should value a variation where the rules provide for a ‘fair valuation’ to be made. In particular, what, allowance should be made for overheads and profit in such a valuation.

Most forms of contract used locally provide for a ‘fair valuation’ (or similar wording) to be made when the works to be valued can not be valued at either Contract Rates, or rates based upon Contract Rates. In such a situation a quantity surveyor will generally build up a new rate, based upon the actual costs incurred by the Contractor (provided such costs are reasonable when compared with the market rates). But what allowance should he make for overheads and profit?

The common thinking of quantity surveyors on this point is firstly that an allowance should be made to include for overheads and profit, and secondly that the allowance should be the same as the overhead and profit percentage contained in the Contract Rates. By doing this, quantity surveyors argue, a fair valuation maintains the same competitive bargain as the parties accepted when they entered into the Contract.

This is certainly the approach that I have always adopted, and judicial support prim facie appeared to be given for this position in the case of Weldon Plant Limited v. The Commission for the New Towns [2000]. However I have had cause to reconsider this case in some detail recently and have concluded that the matter may not be quite so straightforward as I originally considered.

For ease of understanding I will summarise the facts of the case. Weldon Plant entered into a contract with the Commission for the New Towns for the construction of Duston Mill Reservoir. The contract incorporated the ICE Conditions, 6th Edition. The material to be excavated consisted of clay and gravel. Since Weldon were to be able to sell the gravel the contract rate for gravel removal was negative £3.60/m³. The clay was however to be carted to an off-site tip for which the rate was £3.66/m³. The contract made provision for Weldon, at its own risk, to excavate below the design level for the bed of the reservoir (55.06 AOD) and to obtain more gravel which it would also be entitled to sell. On 20 November 1995 the Engineer issued Site Instruction 17 which required Weldon to excavate all the gravel below the bed and to back fill with clay to the design level. Weldon notified the Engineer that this instruction would give rise to a claim. The Engineer valued the additional gravel extraction and clay backfill at bill rates.

The matter went to arbitration where the arbitrator firstly decided that the Engineer’s valuation was incorrect and concluded that a fair valuation should be made. However he then concluded that the basis of determining a fair valuation was that such valuation should leave Weldon in the same financial situation it would have been in had the Instruction not been given, i.e. a loss and expense or damages type approach. In then making such a valuation he assessed the cost of the works themselves but refused to add any allowance for head office overheads or for profit.

The matter was appealed to the courts where the following question of law was considered:

“Whether on the facts found by the arbitrator, clause 52(1)(b) of the ICE Conditions permits a fair valuation to be made which excludes [profit and] an allowance for overheads on the basis that the contractor has to establish that it either incurred additional overheads or that it was denied overhead recovery.”

His Honour Judge Humphrey Lloyd QC held that the answer was no. He considered that Weldon were correct in their assertion that the arbitrator was in error in his approach. In his judgment he held that:

“…..Clause 52(1) of the ICE Conditions contemplated that the contractor would be able to recover in a valuation of a variation those elements included in the contract rates or prices for overheads and profit. Accordingly, in the absence of special circumstances a fair valuation under clause 52(1) of the ICE Conditions had to include an element of profit and an element to cover the contribution the contractor made towards the fixed or running overheads.” (Emphasis Added).

These words have been taken to confirm firstly that allowance for overheads and profit should be made in a fair valuation and secondly that the allowance should be the same as that contained in the Contract Rates.

The first point is undoubtedly correct. The commentary to the Building Law Report stated that the case held that ICE Clause 52 (1) contemplates that a contractor will recover in the valuation of a variation those elements included in the contract rates or prices for overheads and profit and importantly that a valuation would not be a fair valuation as required by the ICE Conditions if it did not include each of the elements which are ordinarily found in a contract rate or price namely elements for the cost of labour, the cost of plant, cost of materials, cost of overheads and profit.
However the second point, i.e. that the allowance should be the same as that contained in the Contract Rates, is not expressly mentioned in the commentary to the Building Law Report, and upon closer analysis of the decision, appears now to be in debate.

In his analysis His Honour Judge Humphrey Lloyd QC gave separate consideration to site overheads, head office overheads and profit and concluded the following:

**Site Overheads** The Judge held that site overheads could only be recovered if in fact they were incurred or increased as a result of the variation because otherwise he considered such costs would be or would have been recovered from original Contract work. On this point therefore he agreed with the arbitrator’s approach that time related overheads required substantiation. It would appear wrong therefore to simply allow the same percentage allowance (or indeed any percentage allowance) for site overheads as included in the Contract Rates.

**Head Office Overheads** With regard to head office overheads the Judge held that unlike site overheads the contractor does not have to demonstrate that he has incurred additional head office overheads. However he considered that the appropriate allowance to be used should not be that contained in the Contract Rates but a percentage that derived by reference to the contractor’s accounts (i.e. as would be used in a prolongation cost assessment made by the Emden formula).

**Profit** The judge considered that unless there were very special circumstances the contractor would generally be entitled to profits for a variation, valued under a fair valuation.

However there was again the suggestion that the allowance for profit under a fair valuation does not have to reflect that allowed for at the time of tender. But in this respect it is not entirely clear how the allowance for profit should be ascertained, particularly because at another point in the judgment his Honour Judge Humphrey Lloyd QC has held that under a fair valuation, adjustment can be made to reflect the profit levels in the Contract Rates. Accordingly it would seem that one might argue that the profit allowance contained in the Contract Rates remains the applicable allowance.

This analysis is a good example of why it is always important to read the entire judgment of a case. A brief review of the summary and the commentary appears to conclude that for a fair valuation it is appropriate to make allowance for overheads and profit within the valuation and that allowance should be the same as included in all the other Contract Rates. However a careful reading of the judgment indicates that whilst the first point is correct, the allowances to be actually included vary depending upon whether one is considering site overheads, head office overheads or profit, and certainly in the first two cases the allowance will be different from that contained in the Contract Rates.

This is a different approach to the one I have always adopted, I have always considered it correct to adopt the same percentages for overheads and profit and contained in the Contract Rates when making a fair valuation. I have done this because I felt that the rates assessed under the three valuation rules should be assessed on a consistent basis. The approach suggested by his Honour Judge Humphrey Lloyd potentially results in an inconsistent result, and so I will look forward to any further clarification by the courts on this point.

From Deflation to Inflation

**Introduction**

Hong Kong has been living with deflation for six years. Suddenly the arrival of inflation may seem a bit far-fetched but it is not, according to one important element in Hong Kong’s composite consumer price index (CPI), a major indicator of the inflation/deflation trend.

The all-important element is the rent of private residential properties, which forms 25% of the CPI. The June 2004 CPI registered a fall of only 0.1% from that of 2003, a very negligible figure and the lowest for a long time. In between this period, rent has actually risen since the beginning of 2004.

Inflation Signaled by Rental Increase

The property market has undoubtedly recovered since late last year. Residential leases executed since then have largely registered increases in rent. Although not as rapid as house prices, residential rental value has, since the start of 2004, increased by about 10%.

In an exercise to focus rents on new leases only (disregarding the tradition way of registering existing or old leases as well), the CPI would have already shown an inflationary trend, as shown in Chart 1 below. Here, deflation would have dissipated in March 2004 and the June CPI would have seen inflation at 3.63%.
thus discouraging property investment whose return always fell short of the former. Inflation, however, takes a large slice out of the interest rate, reducing it to a mere 0.11 and this time round, as compared with a peak of 9.75% (See Chart 3 below).

**Inflation as a Favourable Factor**

It may seem odd, but inflation can actually foster rental growth. With inflation, there is always a possibility of salary increase, meaning a higher disposable income that can be channeled into higher rental or mortgage payment. As a tradition, many public and private corporations use inflation as a yardstick in salary adjustments. From 1982 to 1996, for example, the individual median income has kept pace with inflation. On the other hand, during the deflation years, it has remained unchanged as employers chose to freeze the pay scale. See Chart 2 below.

**How the Property Market Would Fare**

With the economy steadying and low inflation possibly materializing, there is every reason to expect the property market to steady itself, even improving, albeit at a slower pace.

Of various sectors in the residential market, the small-to-medium sized flats will be the most popular and will become the chief motivator. As such, with an estimate of 31,500 resale units in the second half, the whole-year sale forecast of 2004 should be about 70,000, exceeding last year’s secondary market by about 52%. (See Chart 4 below)

**Inflation to Stimulate Investment**

During deflation times, the real interest rate, in fact, stayed high,
Growth in Tourism Industry

After the fading out of SARS in July 2003, tourism in Hong Kong has rebounded sharply and the number of visitors continues to achieve historical high records. In May 2004, there were some 1.69 million tourists visiting Hong Kong. This represents a 297% increase over the same month last year, and 27.2% growth on the May 2002 performance. For the first five months of 2004, total arrivals stand at 8.37 million, a growth of 60.2% compared with the same period in 2003 and 32.2% with that of 2002. The Hong Kong Tourism Board expects there will be 20.5 million arrivals in 2004, which is 38% ahead of 2003.

The number of tourist arrivals is likely to increase due to the continuation of new Provinces and Cities becoming eligible for the Mainland Individual Visit Scheme, the opening of Disneyland in 2005 and the Beijing Olympic Games in 2008 which will provide a strong foundation for tourist arrival growth in the next 5 to 10 years. It is expected that the annual number of arrivals will reach 37 million in 2011 and 70 million in 2030. In tandem to the increasing visitors, the demand for hotel rooms will have to rise and current supply will be totally inadequate.

Current Supply & Demand Situations

In May 2004, 62.6% of all visitors stayed for one night or longer in Hong Kong, leading to an occupancy rate of 84%. Room rates have risen accordingly. The average achieved hotel room rate was HK$731 in May 2004, a 23.7% improvement on May 2003 figure. Hong Kong room rates are the highest compared with neighbouring cities.

However, at current levels, the supply of hotel rooms will not match the increase in visitor arrivals. At present, there are 109 hotels providing some 44,300 hotel rooms in Hong Kong, rising to 125 hotels in 2005 with 50,800 hotel rooms, representing a 14.6% growth. The shortage of hotel rooms will severely limit our capacity and overnight visitors, together with their spending will be lost. The situation is acknowledged by Government on their attempted pilot project of turning Home Ownership Scheme units into hotel rooms, which was eventually cancelled due to technical reasons.

Despite the surge in rents and prices since July 2003, some grade B office buildings are still facing low occupancy problems. It may be attributable to dilapidated building conditions, poor ancillary facilities, inconvenient location, and low quality finishes and decoration. The supply of new Grade A offices and the narrowing gap of rental between Grades A and B invites even further fierce competition. Rental levels of these buildings remain...
low and it is difficult to improve the current situation unless substantial improvement or alternation is introduced. Rather than renovating to existing office use in a continuing competitive market, some owners try to convert existing buildings to hotel rooms by modifying internal layout without alteration of structure and foundations. This trend will continue especially in traditional tourist areas such as Tsim Sha Tsui and Wan Chai.

**Office Conversion**

One of the advantages of this conversion is time saving. Although demolition and rebuilding provides less flexibility in design, the construction period can be shortened to less than 2 years which can allow owners to fight for substantial market share before other competitors enter the market. Another merit is cost savings. The shorter the construction period, the less the interest costs.

The conversion of office to hotel, although considered to be less complicated than redevelopment, still requires compliance with three development controls: town planning control, lease control and building control.

**Statutory Controls**

**Town planning control** is to ensure that hotel use of an existing site complies with the permitted use (Column 1) of town plans. In general, office buildings situated in commercial or residential/commercial zones are permitted for hotel development. However, if it is found that hotel use does not appear in Column 1, a planning application is required.

**Lease control** is the contractual binding agreement by way of a lease between the grantee and the Government. Some leases do not impose any restriction on user (virtually unrestricted in some older leases) while other do. If there is an explicit clause stipulating prohibition of hotel development, lease modification is required and in many circumstances premia are also payable for any enhancement in value.

**Building control** is enforced by Buildings Ordinance (Cap 123) which governs that all overnight stay (inclusive of hotel) developments should follow requirements of domestic developments, which apparently exclude office premise. Substantial alteration needs to be done to fulfil the domestic requirements and can be very expensive. However, Section 23A of the Regulations, which came into effect in November 2001, provides exemption to hotel development. It states that the Buildings Department has discretion to allow non-domestic plot ratio and site coverage requirements in hotel development subject to the following:

- The lot itself and the environs are suitable for hotel development;
- There is adequate traffic capacity in the surrounding area to cope with the increase of pedestrian and vehicle flow as a result of hotel development;
- The development should provide ancillary facilities relating to normal hotel operations;
- Central air conditioning and hot water supply are provided;
- There is evidence that a hotel licence will be obtained under section 9 of the Hotel and Guesthouse Accommodation Ordinance (Cap 349).

Although non-domestic plot ratio and site coverage are permitted for hotel use under the above conditions, in the course of conversion, building design requirements stipulated in the Ordinance are also obligatory. A number of items should be noted as major differences between offices and hotels. They include:

- **Corridor** – Hotel developments generally impose a more stringent requirement in terms of width of corridor, size of lift lobby and fire resistant/fighting provisions.
- **Means of Escape** – Hotel development generally has more stringent provisions in terms of number of staircases and fire resistant/fighting facilities.
- **Air conditioning** – Some old office buildings employ window type air conditioning units which are not sufficient for hotel developments where central air conditioning systems are mandatory.
- **Electricity supply** – Consumption of electricity may be more in hotels than in offices because of 24 hour central air conditioning system and lighting.
- **Water supply** – Water usage for hotels is definitely higher than offices. Enlargement of water tanks and installation of hot water systems are necessary.

It may be noticed that many alterations will impose extra loads on the existing structures. Therefore, structural examination is essential.

**Financial Viability Analysis**

Despite the promising prospect of hotel development in the next decade, the viability of such conversions should be examined to ensure that income from hotel use outweighs the conversion costs.
and the opportunity cost of office use. The impact of the “zero” rental period during conversion should be factored into any feasibility study.

In the conversion of an office building to a hotel, the most fundamental cost is the income generated from the existing use, i.e. office use, without any modification. It is known as the “do nothing” scenario. This is the most conservative approach in the management of an asset whereby the owner receives income similar to past history.

While “do nothing” can provide secure income without incurring any cost, it cannot provide added value in a fast-changing economy, especially when the value of older offices is declining. Therefore, some owners may consider to take the risk and invest in a more aggressive way to renovate the existing office to a hotel in the expectation that their future income will be greater after taking into account the conversion costs.

Viability can be summarised in a simple formula as follows:

\[ P = H - C - L - O \]  

where,

- \( P \) = the viability of conversion
- \( H \) = the value of hotel
- \( C \) = the cost of conversion
- \( L \) = the rental income during conversion period
- \( O \) = the value of office

From the formula (\(^{*}\)), if \( P \) is positive, the value of the hotel conversion is more than the sum of value of the office, the cost of conversion and the loss of rental income during the conversion period. This means that the conversion action creates extra income over existing office use, and the conversion is worthwhile. The conversion cannot create enough extra income to cover the conversion and other costs when the outcome is the reverse.

Even if the viability of the conversion is positive, it should be noted that the rate of return should be well above the market level. Since every penny invested should generate a reasonable reward to cover the associated risks. Common parameters to measure the rate of return include return on asset (\( P/O \)) and return on cost (\( P/C \)). Generally, both of them should not be less than the interest rate of the Government Bond (risk free threshold).

**Conclusion**

The conversion of offices to hotels could not only be a solution to poorly performing office buildings, but also provide a shortcut to tackle the shortage of hotel accommodation, especially in those prime tourist areas where old and dilapidated office buildings are commonly found. The urban landscape will also be improved. Owners of these buildings should start to think about the possibility of such conversations in order to cater for the huge supply of visitors.

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