

Insights

HK COURT OF APPEAL CONFIRMED MODERN TEST ON PENALTIES IN THE EMPLOYMENT CONTEXT

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Introduction

In the recent important decision of *Law Ting Pong Secondary School v Chen Wai Wah* [2021] CA 873, the Hong Kong Court of Appeal adopted the modern test for penalty clauses as laid down in the UK Supreme Court decision in *Cavendish Square Holdings BV v Talal El Makdessi* [2016] AC 1172. In short, the modern test is that a clause will be invalid as a penalty if the clause is out of all proportion to the innocent party's legitimate interest in enforcing the contract. This modern test replaces the old test which looked into whether a clause was unconscionable and calculated more to discourage breach than facilitate compensation.

Background of the case

The claimant was a school, which published a newspaper advertisement in June 2017 for the recruitment of a teacher. The defendant, who then was a teacher at another school, applied for the position. In July 2017, the school decided to recruit the teacher, and the parties entered into an employment contract. The teacher was supposed to report for duty on 1 September 2017. On 22 August 2017, the teacher informed the school that he would not report for duty on 1 September 2017 because he had decided to stay on with the school at which he had been teaching. The school then demanded that the teacher make payment in lieu of notice pursuant to the employment contract.

The termination provision in the employment contract that was central to this case was as follows:

“Termination of Appointment and Period of Notice:

Without prejudice to [the claimant's] right of summary dismissal, the Teacher's employment may be terminated during the contract period by either party, by giving to the other three months' notice in writing or by making a payment equal to the amount of three months' salary in lieu of notice. A combination of notices and an undertaking to pay wages in lieu of notice to satisfy the three months' notice period would also be accepted.”

The school brought a claim against the teacher, in the Labour Tribunal, for payment in lieu of notice. The Tribunal found in favour of the school. On appeal to the Court of First Instance, the judge held that the teacher was not liable for payment in lieu because the teacher's employment did not commence until 1 September 2017, and therefore the payment in lieu provision had not come into effect. The school then appealed to the Court of Appeal.

Takeaway points from the decision

After holding that both parties were bound by the terms of the employment contract to give three months' notice or make payment in lieu of notice if they wished to terminate the employment contract, the Court of Appeal then turned to the issue of whether the termination provision was unenforceable as a penalty clause, which is the focus of this case note.

On the issue of penalty, the Court of Appeal held that the doctrine of penalty was not engaged in this case, and in any event, the termination provision was not unenforceable as a penalty clause. The main takeaway points from the Court of Appeal's decision are as follows:

1. It is confirmed that the Hong Kong courts will adopt the modern (and wider) test for penalty clauses as set out in *Cavendish*. In applying this test, the court "*should first identify the legitimate interest of the innocent party that is being protected by the clause, and then assess whether the clause is out of all proportion to the legitimate interest by considering the circumstances in which the contract was made*".
2. Under the old test¹, the courts were required to look at whether the clause in question had a deterrent purpose (*in terrorem*) or whether it was a genuine pre-estimate of loss. Under the new test, these considerations are subsumed by the broader enquiry into the legitimacy of the interest that the provision purports to support.
3. The Court of Appeal also confirmed that the doctrine of penalty only is engaged where there has been a breach of contract. The doctrine is not applicable to a contractual provision which provides for an obligation to pay a certain amount of money by way of a primary obligation. The reason is that the court will not review the content of the substantive primary obligations which the parties have agreed. In this case, the termination provision gave the parties a right to terminate by payment in lieu of notice². Payment in lieu of notice was a contractually agreed and lawful method to terminate the employment contract, and a claim for payment in lieu was not a claim for damages for breach of contract. Given that the teacher's obligation to make payment in lieu was a primary obligation to pay rather than a secondary obligation arising upon the breach of a primary obligation, the doctrine of penalty was not engaged.
4. Even if the doctrine of penalty was engaged (which was not in this case), the Court of Appeal found that the termination provision was valid, because the school had a legitimate interest in ensuring the teacher's performance of his contractual obligations. In particular, the school had

responsibilities to its students and required a sufficient number of teaching staff, so as to avoid or minimise impacts on the students' learning progress. The court also found that the three-month notice period or the payment in lieu provision was not out of proportion to the school's legitimate interest in enforcing the employment contract.

5. The court expressly recognised that termination by notice or by payment in lieu is common in employment contracts, and that it would be an unwelcome complication to introduce the doctrine of penalty into the employment context. It will be difficult in the future to challenge this type of provision in employment contracts by arguing that it is a penalty.

1. As set out in the decision of *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co* [1915] AC 79.

2. Or by giving notice, or by a combination of notice/payment in lieu.

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