Contractor’s Right to Stop Work on Non-Payment: A Comparative Perspective from Hong Kong

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Abstract

Cash flow is the lifeblood of the construction industry worldwide. Yet, unlike many other jurisdictions, Hong Kong does not yet have any security of payment legislation or any solid plan for the same. Hence, the right of contractors to stop work and terminate the contract in case of non-payment is essentially a matter still regulated by the ambit of the common law. In the circumstances, such unique features of Hong Kong also present a case worthy of investigation from a comparative perspective, in respect of the contractor’s dilemma as to whether to continue working without payment.

Through reviewing recent case examples in Hong Kong and other jurisdictions, this paper examines and compares the legal landscapes regulating the right to stop work on the part of contractors in non-payment situations. In addition, it also seeks to highlight those factors affecting the exercise of such a right that those who find themselves in such situations, or those who need to deal with such situations should be alerted to, in order to guide appropriate approaches to their resolution.

Keywords: Non-payment; Security of payment; Repudiation of contract; Hong Kong

1. Lifeblood in Construction Industry

The construction industry in Hong Kong has gradually recovered from the economic recession in the past 3 years. This however does not necessarily mean that getting paid the right amount in a timely manner, will no longer be a problem for contractors. Indeed, there are some common features inherent in the worldwide construction industry, that make securing cash flow a vital aspect to the survival of every contractor in the business. The construction industry is an industry characterized by operations often with limited capital backing. Construction activities are often subject to a high level of risks and tender prices are inserted with significant
uncertainties on the basis of technical and financial assumptions affecting the ultimate pricing; contractors are paid in arrears and capital funding for the works by overdrafts, trade credits or other interim means as the works progress is almost unavoidable. Most of the contractors are unsecured creditors of the parties whom they have contracted to work for, and, hence the cascade of payments from the project owners from the top downward is critical for the cash flow to all concerned. Indeed, as in many other jurisdictions, the typical organization of construction projects in Hong Kong is somewhat pyramidal in structure. The project owner enters into contract only with a main contractor that sub-contracts out some or a substantial part of the actual works to various sub-contractors while retaining in itself the administrative and supervisory tasks. The various sub-contractors may well in turn further delegate the actual tasks of execution of the works to others. This chain of sub-contracting can go on much further. As observed in a April 2005 paper of the Environment, Transport and Works Bureau to the Hong Kong Legislative Council, it is remarked that: “Sub-contracting is a common practice in the construction industry. If properly managed by contractors it will facilitate the execution of works in a cost-effective manner with efficient use of resources. However, in the absence of proper management, uncontrolled subcontracting could have adverse impact on the progress and quality of works, not to mention the adverse public image on Government.” Thus, the inherent features of the construction industry, when coupled with the extensive use of further sub-contracting, renders cash flow critical for most small and medium sized contractors these days and, if payments are held up, it can be enough to tip them over the edge. This is the case in Hong Kong; this is also the case elsewhere [i].

‘Non-payment’ here is meant to cover situations where there is lack of correct or timely payment or refusal of total payment from the employer or upper tier contractor during the progress of the works, whether such payments are genuinely disputed or otherwise. When faced with the situation of non-payment during the progress of the works, the contractor has a huge dilemma to handle. Some standard forms of contracts in Hong Kong have provided for the termination by the contractor’s giving notices to the employer in cases on non-payment. However, similar provisions are seldom found in sub-contracts in Hong Kong and it is not uncommon for such provisions to be deleted from the contracts in some private sector jobs. The contractor may naturally wish to suspend or stop the works pending receipt of proper payments. This, without express contractual entitlement to do so], is often a breach or even a repudiation of the contract. Repudiation means a fundamental breach that goes to the root of the contract and has the effect that, once validly accepted by the innocent party, it discharges the innocent party from further performance of the contract and to sue for damages immediately. As laid down in the case of*Hongkong Fir Shipping Co. Ltd. v. Kawasaki Kisen Kaisha Ltd.* [ii], as held by Diplock L.J., the test on whether an event which 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 should obtain as the consideration for performing those undertakings?”.

Hence, in such circumstances of non-payment, there are competing considerations. Many construction contracts in Hong Kong do provide that disputes are to be resolved by arbitration
and arbitration shall not be proceeded with until the completion of the works. See, for example, the Agreement and Schedule of Conditions of Building Contract for Use in Hong Kong (1976 Ed.) by the Hong Kong Institute of Architects and Royal Institution of Chartered Surveyors (Hong Kong Branch), which is still popularly used in the private sector. Also, with the nature of some payment disputes, they are not always suitable for resolution by summary judgement even if the disputes can be brought before court. Thus, on the one hand, if progress payments are not forthcoming, the disputes over such payments may need to be referred to litigation or arbitration, which can take months, if not years to resolve [iii]. Also, payment disputes are also complicated by the use of “pay-when/if-paid” clauses in the construction industry, allegations of defective works or delay to completion of the works, and set-off or abatement claims for contra charges or other deductions [iv]. This means effectively that such disputes cannot be resolved within a short time and no cash flow can be inward coming. Therefore, the contractor has to rely on its own means to finance the works if to continue the works. On the other hand, the contractor is often still under an ongoing obligations to proceed with the works with diligence to meet the agreed progress or programme. Failure in meeting these obligations is usually visited with deduction of damages for delay, whether liquidated or otherwise, and a right of the employer or upper tier contractor to terminate the contract and sue for consequential losses, where the contractor simply suspends or stops working on site. In such circumstances, instead of getting paid for the works done, the contractor may be held liable for damages for the delay and extra costs for the completion of the works by others. Accordingly, ‘invalid’ suspending or stopping the works all together, can expose the contractor to disastrous consequences.

2. Legal Landscapes for Right to Stop Work

This dilemma arises from the common law position as regards the right (if any) of a contractor to stop work, treating the contract as terminated, if not getting timely and correct progress payments as agreed in the contract. The starting point for this can be that there is no general right in common law to suspend work if payment is wrongly withheld. This is illustrated in the classic case of Lubenham Fidelities & Investment Co. Ltd. v. South Pembrokeshire District Council [v]. The employer in this case withheld interim payments by deducting liquidated damages on wrongful advice by the architect. The contract was in the JCT 63 form. The contractor wrote to terminate the contract for such a breach and ceasing work on site. This led to the employer sending out determination notices for the contractor’s ceased works without reasonable cause and the contractor also served notices to terminate the contract for the employer’s failure to effect interim payments as certified, also issuing a writ. The UK Court of Appeal held that the contractor, who was indeed the bondsman who choose to take over the contract to perform it rather than paying on the performance bond, had repudiated the contract by ceasing works without reasonable cause notwithstanding that the employer were wrong in deducting liquidated damages at that stage. Thus, by serving the notices of termination for non-payment and issuing a writ thereafter, the contractor was held to have indicated an intention not to be bound by the contract, leaving the employer with no alternative but to accept the repudiation. In giving the judgment of the court, May LJ said: “Whatever be the cause of the under-valuation, the proper remedy available to the contractor is, in our opinion, to request the
architect to make the appropriate adjustment in another certificate, or if he declines to do so, to
take the dispute to arbitration under clause 35…”.

Also, in Mersey Steel and Iron Co. v. Naylor, Benzon & Co. [vi], it was held that on the facts of
the case the party which had postponed an installment payment under erroneous advice had not
shown an intention to repudiate the contract so as to release the other party from further
performance. In the judgement of Earl of Selborne L.C., it was stated that “You 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; you must examine what that
conduct is, so as to see whether it amounts to a 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.” Therefore, how the legal
consequence of a breach is to be ascertained is regarded as a matter to be determined primarily
from the terms of the contract itself, and the facts and practical results of the breach have to be
examined to see whether it will go to the root of the contract and accordingly amount to
repudiation. As noted in Decro-Wall International S.A. v. Practitioners in Marketing Ltd by
Salmon L.J: “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.”[vii].

This approach has support from also the New Zealand case of Canterbury Pipe Lines Ltd. v. The
Christchurch Drainage Board [viii] where McMullin J. held that: “It is true that where a
stoppage in payments is temporary only, in the sense of being no more than delayed rather than
withheld, the contractor's rights may not extend beyond a right to sue the employer. There may
be some cases in which the contractor can treat the stoppage as repudiation. Much will depend
on the facts.”

However, the difficulties associated with this approach for an innocent contractor is that non-
payment, in itself, does not normally amount to a repudiation that can be relied on to discharge
the innocent party from further performance of the contract. All the circumstances have to be
assessed to search for an intention not to be bound by the contract on the part of the defaulting
party. Indeed, a contractor in such situations is further faced with the risks and consequences of
a wrongfully terminated contract or stopped work, when the non-payment is merely a breach
and not sufficient to become a repudiation, whereby entitling the innocent contractor to sue for
damages for the breach associated with the non-payment and, normally, merely to recover
interest for late payment. In that case, the ‘innocent’ contractor can be liable for wrongful
repudiation of the contract by its act.

Uncertainty and complications in this regard are further highlighted by the cases like James
Shaffer Ltd. v. Findlay Durham & Brodie [ix], Sweet & Maxwell Ltd. v. Universal News Service
Ltd. [x] and Woodar Investment Development Ltd. v. Wimpey Construction U.K. Ltd. [xi], which
firmly lay down the principles that a party who bona fide relies upon an express provision in a
contract in order to rescind or terminate a contract, should not, by that fact alone, be treated as having repudiated his contractual obligations if he turns out to be mistaken as to his rights.

Partly to cater for these problems associated with non-payment, legislative solutions have been introduced in various common law jurisdictions, starting from the enactment of the UK Housing Grants, Construction and Regeneration Act 1996. A statutory right to suspend works on non-payment of contractual sums otherwise due is conferred on a contractor engaged in a construction contract by virtue of section 112 this 1996 Act. When a sum due under a construction contract is not paid in full by the final date for payment as regulated by Sections 109 to 113 of the 1996 Act, this right becomes exercisable by giving 7-day notice of intention to suspend performance, stating the ground(s) on which it is intended to suspend performance, unless an effective notice to withhold payment has been given to the contractor. This right to suspend work continues until the party in default makes payment in full of the amount due. For calculating time under the construction contract, any period during which performance is suspended in pursuance of the right conferred by this section shall be disregarded in computing for the purposes of any contractual time limit the time taken, by the party exercising the right or by a third party, to complete any work directly or indirectly affected by the exercise of the right. By requiring the use of notice to withhold payment, no one may withhold payment of money due to the other party without giving him advance notice of the intention to do so [xii]. Further, contract conditions which provide that pay-when/if-paid arrangements are also prohibited except in circumstances where the non-payment arises from insolvency of the upper tier payer [xiii]. Coupled with the use of statutory adjudication for interim binding resolution of disputes [xiv], the 1996 Act aims at reducing disputes in construction contracts and moving them upstream for resolution as early as practicable, on a provisional interim basis [xv].

Since 1996, legislation similar to the above have been enacted in various other common law jurisdictions. These include the Building and Construction Industry Security of Payment Act of 1999 in New South Wales, of 2002 in Victoria, of Queensland in 2004, and the Construction Contracts Act 2004 in Western Australia; the Construction Contracts Act 2002 in New Zealand; and of the Building and Construction Industry Security of Payment Act 2004 in Singapore. In Malaysia, a legislative move towards the enactment of the Construction Industry Payment and Adjudication Act 2007 is also in progress. Though operational details differ, all of these models of legislation have, inter alia, one common feature --- a mechanism to confer a statutory right on the contractor to a construction contract to suspend carrying out of the works when payment due is not effected in time [xvi].

Of course, every solution can breed new problems. For instance, in respect of the UK Housing Grants, Construction and Regeneration Act 1996, disincentives for exercising the right to suspend work are observed. These are centered on the costs of suspension and include considerations for the costs of suspending and remobilising performance, under a construction contract, the inconvenience and cost of remobilising immediately upon payment of the outstanding debt, and the inconvenience and cost of having to suspend all obligations under the contract [xvii]. Reviews and ways for improving the current legal regime created by these legislation are indeed ongoing [xviii]. However, the popularity of security of payment
legislation being adopted across various jurisdictions indicate that payment problems, while not unique to the construction industry, are often seen to be worse in this industry than in others. The multi-tiered industry hierarchy, the low capital backing of contractors, the heavy reliance on cash flows to sustain business, and the not uncommon criticism for not maintaining consistently high standards of ethical conduct in the worldwide construction industry also are features of the construction industry in Hong Kong [xix]. However, as the matter now stands, Hong Kong does not yet have any security of payment legislation or any solid plan for the same. Hence, from the perspectives of common law principles, Hong Kong is a case worthy of investigation, from a comparative perspective, in respect of the contractor’s dilemma as to whether to continue working without payment.

3. Approach in Hong Kong

Obviously, the starting point of a contractor’s right to stop working on non-payment must be the contract.

As an illustration, clause 26 of the Agreement and Schedule of Conditions of Building Contract for Use in Hong Kong (1976 Ed.) by the Hong Kong Institute of Architects and Royal Institution of Chartered Surveyors (Hong Kong Branch) (“the HKIA/RICS Form”) provides for the usual two-notice procedure for determination of the contract by the contractor for non-payment of certified payments. This entitles the contractor to give to the employer the initial notice stating that a notice of determination will be served if no payment of the certified amount is made within the next 7 days and the sending out of the notice of determination thereafter. There is a proviso that no such notices can be served unreasonably or vexatiously [xx]. To validly exercise such a right to bring the contract to an end, the contractor is generally required to strictly comply with all the stipulated procedural requirements, e.g. as to the timing and format of the notices [xxi]. Termination of the contract under clauses like this is often described as contractual termination, as distinct from common law termination, when repudiation exists to discharge the innocent party from further performance of the contract. It is well settled that contractual termination co-exists with common law termination, as illustrated in Tridant Engineering Company Limited v. Mansion Holdings Limited [xxii], where, applying Lockland Builders v. Rickwood [xxiii], it was held that, in deciding clear express words must be used to rebut the presumption neither party intends to abandon any remedies for its breach arising by operation of law.

In respect of terminating the contract at common law, the Hong Kong Court of Appeal has in a recent decision reviewed the governing legal principles. This is the case of Creatiles Building Materials Company Limited v. To’s Universe Construction Company Limited [xxiv], an example of repudiation at common law arising out of non-payment of progress payments. The facts of the case arise from a sub-contract to apply spray coating to a building. The spray was to be applied to the four elevations of the building in five coats on each wall. Under the sub-contract, the contractor was to pay a 10% deposit upon signing of the agreement, 30% upon materials delivered on site, and the “...balance by each 14 days interim payment during work-in-progress”. There was no problem with the deposit and the 30% payments. After
commencement, the contractor did not settle the sub-contractor’s debit note for 20% of the balance of the contract price due based on the progress of the spraying works, in breach of two subsequent promises to pay. Through its lawyers, the sub-contractor wrote to the contractor stating that if payment was not made by a certain time, it would treat the sub-contract as having been repudiated by the contractor. No payment was effected but the contractor wrote back stating that the reason for non-payment was that all five coatings to one elevation had to be completed before the sub-contractor could claim payment. The sub-contractor therefore left the site and claimed for repudiation of the sub-contract on the part of the contractor. At first instance [xxv], it was held that the non-payment by the contractor amounted to repudiation, entitling the sub-contractor to terminate the sub-contract. The contractor appealed arguing that the non-payment was not a fundamental breach amounting to repudiation and that the mere fact that it had insisted on its rights, even though it might have been wrong about them, was not to be treated as evincing an intention to repudiate the contract.

In the judgement of Cheung JA, the Hong Kong Court of Appeal re-affirmed the general principle, as a starting point, that there was no general right in common law to suspend work if payment was wrongly withheld but also accepted that the authorities clearly recognised that a deliberate refusal to make an interim payment was capable of amounting to a repudiation of the contract. After review of cases in other jurisdictions, the Court of Appeal concluded that “...ultimately one has to examine the facts of the case to see whether the non-payment amounted to a repudiation”, stating that “…the principle is to consider whether the circumstances of the non-payment show an intention not to be bound”. In applying this approach to the case, the Court of Appeal took into account the facts that the contractor was clearly required to make interim payment every 14 days; that the contractor was in breach of its promises twice to effect the interim payments; that the contractor, by its letter in response, expressed a clear refusal to pay for the work by unilaterally changing the payment method under the sub-contract. It was also observed in the judgement that: “While it would not pay for the interim payment, it would expect the plaintiff to carry on with the work. In other words, the payment term would be changed from cash payment to that of credit payment. This clearly entitled the plaintiff to treat it as a repudiation.” To the defence that the contractor was merely insisting on its own, although mistaken, interpretation of the sub-contract, the Court of Appeal was of the view that “…it may not be a repudiation for one party to put forward his genuine, but bona fide, interpretation of what the contract requires of him but that where that party performs in a manner which is not consistent with the terms of the contract, it is no defence for that party to show that he acted in good faith”. In this case, the Court of Appeal also observed that, when the sub-contractor started work, the contractor was obviously aware that the plaintiff's method of working was to apply one coat to all the four elevations first before applying the next coat; and the contractor had never indicated that this method of work would disentitle the plaintiff from receiving the interim payment even after the debit note was presented. Thus, the defence of the contractor was rejected as there was indeed far from being a bona fide misconstruction of the terms of the contract and the reasons given were considered to be spurious reasons.

The approach of Creatiles Building Materials has been considered in a subsequent case of Hongkong Underground Engineering Ltd. v. Welcome Construction Co Ltd [xxvi], which
concerns a specialist sub-contractor in underground tunneling work. The facts of the case are not uncommon. Under the sub-contractor, interim payment arrangement was to be effected via invoice submitted before the end of each calendar month with payment to be paid within 30 days of receiving invoice. The sub-contractor applied in its first invoice for HK$324,400 and the contractor, via its own assessment, calculated an amount of HK$169,800 but paid only HK$100,000 eventually. In likewise manner, the contractor paid over HK$150,000 for the second invoice, which claimed for HK$338,000 and was assessed by the contractor to be HK$288,000. For the third invoice, the contractor paid in full its assessed amount but with a delay for more than 2 months. No further payments were made in the fourth and fifth invoices. The sub-contractor wrote to the contractor stating that its non-payment evinced an intention no longer to be bound by the contract. To this, the contractor indicated that reasonable sums were withheld for liquidated damages that might be imposed.

In his judgement, Sakhrani J was of the view that the figures of HK$100,000 and HK$150,000 were without contractual basis and, using his words, “...simply a figure plucked out of the air without any calculation...” and, applying Shyam Jewellers Ltd. v. Cheeseman [xxvii], it was 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.

4. Factors for Review

The legal approach that can be drawn out from the above cases is quite clear, though the application may be more complicated as being highly facts-sensitive. What matters most in deciding whether there is a repudiation for non-payment, thereby capable discharging an innocent contractor from continuing the work, depends on an evinced intention not to be bound by the contract, rather than the mere fact of non-payment itself.

From the above, there appear to be certain indicators or factors to watch out for when practitioners in Hong Kong are facing the dilemmas highlighted in this paper, and risk consequences as a result of not getting paid in respect of interim or progress payments. These factors will be extracted from a range of cases and presented in another forum, given space limitations herein. The factors derive themselves from common law and, as such, should also be applicable or of guidance effects in other common law jurisdictions, which have enacted security of payment legislation though it is expected that the need to resort to common law termination in non-payment situation should not be frequent in those jurisdictions. However, some examples of the key factors and indicators to consider from a Hong Kong perspective are
highlighted as below. It is stressed that these are neither meant to be nor capable of being exhaustive.

Examples of the above factors are:-

- Whether there is clear indication of refusal or inability to effect future payments;
- Whether there is a repeated pattern to pay the correct amount despite warnings;
- Whether there is a repeated failure to pay on time despite warnings;
- Whether payments already effected is of amounts with certain contractual basis;
- Whether there is response or reasonable response to support the refusal or default in payment;
- Whether there is prior or subsequent inconsistent knowledge or conduct against the alleged bona fide reliance upon the payment term to refuse timely or correct payment, based on mistaken understanding of the concerned term;
- Whether the reliance upon the understanding of payment term to refuse timely or correct payment is or otherwise can be bona fide;
- Whether there are other consequences evincing an intention not to be bound by the contract.

5. Conclusions

Among the common law jurisdictions, Hong Kong remains one of the few that does not yet have any security of payment legislation. The right of contractors to stop work and terminate the contract in case of non-payment is essentially a matter still regulated by the ambit of the common law. From reviewing recent case examples in Hong Kong and other jurisdictions, some factors affecting the exercise by the contractor of the right to stop work in non-payment situations can be identified and are presented in the format of a checklist of questions. In view of the uncertainties and risks surrounding the exercise of such a right, it will be prudent for those facing such dilemmas to prepare such a checklist, based on the contract conditions, governing legislation and precedents, in order to better assess and respond to such situations, avoiding pitfalls and effectively protecting the legal rights and interests of themselves or their clients.

References


[vi] [1884] 9 AC 434.

[vii] [1971] 1 WLR 361.

[viii] (1979) 16 BLR 76.

[ix] [1953] 1 WLR 106.

[x] [1964] 2 QB 699.

[xi] [1980] 1 WLR 277.

[xii] Section 111 of the 1996 Act.

[xiii] Section 113 of the 1996 Act.


[xxii] [2000] HKEC 656.


[xxiv] [2003] 2 HKLRD 309.

[xxv] [2002] HKEC 1148.

[xxvi] [2005] HKEC 1264 and, also, Owt Asia Ltd. v. Cpcnet Hong Kong Ltd. & Proactive Technology Ltd. (Third Party) [2005] HKEC 2152.