Hong Kong employment – Court of Appeal on interpretation of contracts and (3 – 0) on penalties

16 July 2021

Introduction

The Hong Kong Court of Appeal's recent judgment (of three judges) in *Law Ting Pong Secondary School v Chen* [2021] HKCA 873 is an interesting judgment that: (i) summarises and applies the relevant principles of contractual interpretation; and (ii) found that a clause providing for termination by payment in lieu of a notice period does not engage the law on penalty clauses and, even if it does, such a provision is unlikely to be regarded as unenforceable (unless it is unconscionable or extravagant).

Some key points

- There is a difference between "employment" and an "employment contract'. Depending on the contractual wording of on employment contract (and, in particular, its termination provision), a provision for payment in lieu of notice can be valid even though the period of employment has not begun.
- In interpreting employment contracts, the courts apply normal principles of interpretation. These principles are well-settled under Hong Kong common law and are applied according to the facts of each case. The court first applies the ordinary and natural meaning of the words used and in most cases that should be an end to the matter. However, where the words are genuinely capable of ambiguity the court can (applying a "unitary" approach) consider so much of the factual circumstances, pursuant to which the contract is concluded, as is reasonable.
- A provision in an employment contract that simply provides for payment in lieu of a contractually agreed notice period is not (in the normal course of events) in the nature of a claim for damages for breach of contract – rather, such a provision is a primary obligation to pay as opposed to a secondary obligation arising upon a breach of a contract by (for example) failing to perform. Therefore, a provision for payment in lieu of notice in an employment contract should not engage the law on unenforceable penalties. This is unsurprising and uncontroversial, given that payment in lieu is provided for as a statutory right in section 7 of the Employment Ordinance (Cap. 57).
- Even where the law on penalties is engaged, a payment in lieu of a reasonable notice period (in this case three months) could not be stated to be unconscionable or extravagant and employers will usually have a legitimate interest in having such a contractual provision in place.
- In practice in Hong Kong, termination of an employment contract by an employer or an employee by payment in lieu of notice is quite common.

Background

On 17 July 2017, the defendant (a teacher) accepted a job offer to teach at the claimant school for a period of one year. He was due to start teaching at the school at the beginning of the school year in September 2017. However, approximately ten days before the start of the school year he changed his mind. The contractual documents between the school and the teacher consisted of: an offer letter from the school, the school's conditions of service and an acceptance letter signed by the teacher.

The offer letter referred to the conditions of service for teachers at the school and requested the teacher to sign the letter of acceptance and the conditions of service, which he did within time. The conditions of service provided for a period of employment of one year, commencing on 1 September 2017 – they also provided that either party could terminate the employment by giving the other three months' notice in writing or by making payment equal to the amount of three months' salary in lieu of notice or a combination of notice and payment in lieu to satisfy the three months' notice period (the "Termination Provision"). In the letter of acceptance, the teacher accepted the

appointment "in accordance with the attached Conditions of Service" and that those conditions would come into "immediate effect", including a requirement "to give three months' notice to terminate my employment with the school".

The teacher disputed the school's entitlement to an amount of money representing the payment in lieu and the school brought a claim in the Labour Tribunal (for the sum of HK$139,593.20).

In the Labour Tribunal, the Presiding Officer found for the school on the two principal issues. First, the Termination Provision was incorporated into the employment contract and the offer letter, conditions of service and acceptance letter constituted the employment contract as a whole. Therefore, although the employment commenced on 1 September 2017, the Termination Provision applied with immediate effect. Second, the payment in lieu provision in the Termination Provision was not an unenforceable penalty clause.

The teacher successfully appealed to a judge of the Court of First Instance of the High Court, who reversed the Labour Tribunal's decision. In short, the judge appears to have concluded that the letter of acceptance, and the terms therein, did not form part of the employment contract but were rather the teacher's acknowledgement of the school's offer. The judge also took into account that the teacher needed to give three months' notice "to terminate my employment with the school" while the employment did not commence until 1 September 2017. Therefore, the judge considered that the teacher was not liable for the payment in lieu given that he had not commenced employment. In light of that finding on the first issue, the judge did not need to decide whether the Termination Provision constituted an unenforceable penalty clause.

The school obtained permission to appeal to the Court of Appeal (comprised of three judges) and, after some initial delay because of the courts' general adjourned period caused by the COVID-19 pandemic, the appeal was eventually disposed of (by consent between the parties) on the papers.

Court of Appeal

In a unanimous decision, the Court of Appeal allowed the school's appeal and restored the order of the Labour Tribunal by entering judgment in favour of the school, together with interest at judgment rate from the date of the award and costs (summarily assessed, subject to any further challenge, in the sum of HK$70,000).

As regards the two principal issues – namely, how to construe the employment contract and determine whether it incorporated the Termination Provision and, in the event that it was incorporated, whether the Termination Provision was an unenforceable penalty clause – the Court of Appeal found for the school.

Contractual Interpretation

After having reviewed the relevant Hong Kong and English case law concerning the principles for interpretation of contracts, the Court of Appeal considered that the school's offer letter and conditions of service and the teacher's acceptance letter were a "package deal". In the Court of Appeal's opinion, the judge had focused too much on the teacher's acceptance letter and had failed to consider all three documents in light of the relevant circumstances – therefore, properly construed, the Termination Provision was incorporated into the employment contract. The Court of Appeal appears to have placed significance on the point that parties can generally agree that an employment contract has immediate legal effect irrespective of the time for performance. The Court of Appeal observed (at paragraph 56 of its judgment) that:

"Hence, although performance of teaching duties is to commence on a future date (ie 1 September 2017), as from 17 July 2017 both the claimant and the defendant were both legally bound to perform their obligations under the contract."

Penalty Clauses

In an interesting passage of the judgment, the Court of Appeal reviewed the development of the legal principles relating to penalty clauses and cited with approval the leading authority of the UK Supreme Court – namely, *Cavendish Square Holdings v Makdessi* [2016] AC 1172. The Court of Appeal noted (at paragraph 69 of its judgment) that:

"The true test was held to be whether the clause is out of all proportion to the innocent party's legitimate interest in enforcing the contract. It further recognized that an innocent party could have a legitimate interest in the performance of the contract or some appropriate alternative to performance that goes beyond compensation."

However, to constitute a penalty clause the offending provision had to satisfy a "threshold requirement" of a breach of contract – a contractual provision is not a penalty clause if it does no more than provide that one party to a contract pays another an amount of money by way of a primary obligation. The teacher had failed to establish that the Termination Provision (in particular, the provision for payment in lieu of notice) as a matter substance operated upon a breach of contract ie, that it operated as "a secondary obligation triggered by a breach of a primary obligation" (paragraph 71 of the judgment).

The Court of Appeal (at paragraph 74 of its judgment) held that:

"The payment of a sum in lieu of notice is a contractually agreed method of lawful termination of the employment contract; it is not in the nature of damages for breach of contract. It is a primary obligation to pay rather than a secondary obligation arising upon the breach of a primary obligation of performance."

Therefore, the law of penalty clauses was not engaged because the "threshold requirement" had not been satisfied.

For good measure, the Court of Appeal made it clear (without having to decide the point) that had the law of penalty clauses been engaged it did not consider that the provision for payment in lieu was unenforceable. In all the circumstances, the Court of Appeal did not consider that the provision was unconscionable or extravagant – particularly, bearing in mind that it applied reciprocally and was reasonable, judged at the time that the employment contract was signed by the teacher and by the school's legitimate interests in the run-up to the start of the new school year.

The school's appeal was successful on both principal issues in dispute.

Comment

The outcome in the case is not unexpected. The case is an interesting example of the application of contemporary principles relating to interpretation of contracts. While the Court of Appeal adopted a unitary approach to the interpretation of the three contractual documents in question, the case serves as a reminder for employers and employees to ensure that key provisions are expressly incorporated in conditions of service and consistent with one another – for example, as with any written contract, termination provisions are crucial.

The case also serves as a useful reminder that parties to an agreement can agree that some provisions in a contract have immediate legal effect, irrespective of when performance by one or other party is expected.

As for the legal principles relating to penalty clauses, the Court of Appeal has approved of the legal principles set out by the UK Supreme Court in *Cavendish Square Holdings v Makdessi*, which is the way that the Hong Kong courts were headed. This approach generally allows for a less interventionist approach in keeping with an emphasis on the primacy of written terms agreed between legally competent persons negotiating in good faith – it is, arguably, also in keeping with a generally more laissez-faire approach to business. The Court of Appeal's decision that the Termination Provision did not amount to a penalty clause is unsurprising given that termination of an employment contract by payment in lieu of notice is provided for by statute (section 7 of the Employment Ordinance). Equally unsurprising is the Court of Appeal's suggestion that, in any event, the Termination Provision was not unreasonable given that (for example) it provided for no more than payment of an amount equal to three months' salary (or a combination of payment and notice) and was reciprocal.

In this regard, the last word might be best left to one of the judges in the Court of Appeal, who delivered a short judgment (agreeing with the main judgment) which focused on the issue of penalty clauses in an employment context (at paragraph 7):

"In the context of employment contracts, termination by advance notice or payment in lieu of such notice is quite common. I do not think it is in the interest of the development of employment law to complicate the matter by bringing the concept of penalty to such a common practice."

Contact us

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