

Legal Issues



A Brief Overview of Liquidated Damages under the Laws of the Mainland

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Introduction

One of the most common clauses found in a construction contract is a liquidated damages clause. Those clauses are present in construction contracts in both the Mainland as well as in Hong Kong. However, the legal implications of a liquidated damages clause in the Mainland could be quite different from that in Hong Kong.

This article will give a brief overview of the legal framework for liquidated damages under the laws of the Mainland.

This article will then review two cases decided by the Courts in the Mainland as examples illustrating how the Courts in the Mainland would render judgments regarding liquidated damages.

The Legal Framework

Article 112 of the General Principles of Civil Law of the Mainland provided as follows:

"Responsibility to Pay Damages for Breaching Contracts

The responsibility to pay damages by a party in breach of a contract should accord with the loss suffered by the other party.

The parties may agree in the contract that upon breaches by a party, that party should pay the other side a certain amount of monies for breaching contract, and may also agree in the contract method of calculation of the amount of loss payable as a result of breaches."

Article 112 of the General Principles of Civil Law confirmed the following matters:

- As a general rule, damages for breaches of a contract should be assessed on the basis of loss suffered by the aggrieved party. However, as we shall see in the later part of this article, it is recognised that in some circumstances the concept of liquidated damages is an exception to this general rule under the laws of the Mainland.
- The concept of "liquidated damages" is expressed by the words "..... agree in the contract a certain amount of monies for breaching contract". Some people translate the Chinese words "違約金" (ie monies for breaching contract) into "liquidated damages". Strictly speaking that is incorrect. That

translation ignored the idea that the damages have been "agreed". The writer suggests that a better translation of "liquidated damages" should be "約定違約金" (ie agreed monies for breaching contract).

- In predetermining the monies for breaching contract, the parties may agree on a certain sum. Alternatively, the parties may agree on the method of calculation. In construction contracts, the most usual method of calculation of liquidated damages is to specify a sum accruing on a daily basis.

Article 112 of the General Principles of Civil Law only provided for general principles. Further details are set out in various specific legislations on contract law.

Before 1 October 1999, there were three major legislations relating to contracts, each governing a defined area of contract law in the Mainland. The three legislations were the Economic Contract Law ("the ECL"), the Foreign Economic Contract Law ("the FECL"), and the Technology Contract Law ("the TCL"). In essence, the TCL and the ECL governed contracts made between Mainland entities for technology and non-technology related contracts respectively, while the FECL governed contracts between Mainland and foreign entities (whether relating to technology or not).

Article 20 of the FECL provided, amongst other matters, that "Monies for breaching contract agreed in a contract are deemed to be compensatory damages for breaching a contract.

However, if the agreed amount is excessively higher or lower¹ than the damages caused by the breach of contract, the party may request an arbitral tribunal or a Court for an appropriate decrease or increase". The first sentence accorded with the principle set out in the General Principles of Civil Law discussed above ie that liquidated damages should generally be compensatory, rather than penalising. Article 22 of the Implementation of TCL made similar provisions². The second sentence of Article 20 of the FECL relating to judicial adjustments of liquidated damages will be considered below.

Contrast the above with the ECL which took a different and more intervening approach. Some regulations under the ECL prescribed specific amounts of liquidated damages (eg Article 22(5) of the Regulations on Contract for Work³). Other regulations under the ECL prescribed specific margins within which the parties may stipulate the precise amount of liquidated damages (eg Article 21(5) of the Regulations on Contract for Work⁴).

As from 1 October 1999, with the reform of contract law in the Mainland, the ECL, the TCL and the FECL have been repealed and they are replaced by the Contract Law of the Mainland ("the CL"). The distinction between Mainland and foreign entities was no longer applicable under the CL. Further, the distinction between technology and non-technology contracts was no longer applicable under the CL.

The approach under the CL regarding liquidated damages was more in line with the FECL and the TCL, rather than the approach under the ECL. In particular, Article 114 of the CL provided as follows:

"Monies for Breaching Contract and their Nature

The parties may agree that a party, when breaching a contract, shall pay a certain amount of agreed monies for breaching contract to the other party according to the circumstances of the breach, and they may also stipulate the method for calculating the amount of damages arising from the breach. Where the amount of agreed monies for breaching contract is lower than the amount of loss, the party may request the People's Court or an arbitral tribunal for an increase; where the amount of agreed monies for breaching contract is excessively higher than the amount of loss, the party may request the People's Court or an arbitral tribunal for an appropriate decrease.

If the parties agree on liquidated damages for late performance, the party in breach, after paying the liquidated damages, shall perform his obligations."

Accordingly, the first paragraph of Article 114 of the CL generally accorded with the General Principles of Civil Law, the FECL and the TCL ie that liquidated damages should generally be compensatory, rather than penalising.

Further, the third paragraph of Article 114 of the CL allowed the claim for specific performance after payment of liquidated damages provided that the liquidated damages related to late performance. Thus if a contract involved continuous or periodical performance, payment of liquidated damages in respect of a previous breach regarding late performance would not prevent the aggrieved party from insisting upon future performance of the contract.

In the course of drafting the second paragraph of Article 114 of the CL (ie regarding judicial adjustments of liquidated damages), there was a lot of discussions as to the approach to be adopted. Some advocated that liquidated damages as stipulated by the parties should not be varied by the Courts even if they were greater than the actual loss suffered by the aggrieved party.

Others maintained that liquidated damages should be limited to their compensatory role and that the Courts should be authorised to adjust the amount of liquidated damages should that be excessively higher or lower than the actual loss.

Ultimately, the second paragraph of Article 114 of the CL (which generally accorded with Article 20 of the FECL) provided that the Courts have express power to increase or decrease the amount of liquidated damages. Although the adjustment used "the amount of loss" as a yardstick, the Courts have different approaches depending upon the actual amount of loss relative to the amount of the liquidated damages. If the amount of liquidated damages were lower than the actual amount, the second paragraph suggested that the aggrieved party might request the Courts for an increase. Contrast this with the situation where the amount of liquidated damages were higher than the actual amount, in which case the second paragraph suggested that the aggrieved party might request for a decrease only if the liquidated damages were "excessively higher" than the amount of loss.

The comparative reluctance for the legislature to order a decrease (rather than an increase) in liquidated damages is a subtle recognition that to a certain extent, liquidated damages are of a penalising nature, in that liquidated damages "slightly higher" than the amount of loss should be tolerated, and that liquidated damages should only be decreased if it is "excessively higher" than the amount of loss. Thus in the circumstances where liquidated damages is "slightly higher" than the amount of loss, the liquidated damages becomes penalising in nature and that would be an exception to the general rule that damages for breaches of a contract should be assessed on the basis of loss suffered by the aggrieved party.

Under the tradition of the Common Law, if a liquidated damages clause were found to be a penalty clause, the clause would be struck down. This all-or-nothing approach means that Common Law Courts would compare the amount of liquidated damages

¹ It is not clear in the Chinese text as to whether the word "excessive" is restricted to the word "higher", or whether it is also applicable to the word "lower". The English text is translated without resolving this issue.

² Article 22 of the Implementation of TCL stated that "Where the parties have agreed upon the amount for monies payable for breaching a contract, the monies shall be deemed as compensatory damages for breaches of the technology contract."

³ These Regulations are applicable to contracts for processing, repair, surveying, etc. Article 22(5) of the Regulations provided that "Payment after the date agreed in the contract would attract liquidated damages to the contractor in accordance with the requirements for delay payment of the Chinese People's Bank calculated in accordance with the wages at the rate of 1 in a thousand on a daily basis." According to an Explanation given by the Supreme People's Court dated 21 July 1987, any agreements contrary to Article 22(5) are invalid, and that the relevant amount of liquidated damages payable should accord with Article 22(5).

with the amount of loss on a less frequent basis, in contrast with the Mainland Courts. Nonetheless, should the Common Law Courts find that a liquidated damages clause amounted to a penalty clause, the results would be more drastic (ie striking down a clause), whereas the Mainland Courts would simply make appropriate adjustments in those circumstances.

Unfortunately, none of the legislations provided guidelines as to how the appropriate adjustments should be made. If the actual loss caused by the breach is greater than the liquidated damages, could an aggrieved party claim damages beyond the amount of liquidated damages? Conversely, if the amount of liquidated damages is greater than the actual loss caused by the breach, could an aggrieved party recover the liquidated damages in full?

Regarding the first situation whereby the actual loss caused by the breach is greater than the liquidated damages, there is no presumption that liquidated damages would be the proper compensation for the aggrieved party's loss under the CL⁵. Accordingly, there is no prerequisite before an aggrieved party could claim damages beyond the amount of liquidated damages. The effect of the liquidated damages clause could be varied, if the clause stipulated that the liquidated damages shall be the maximum limit for the liability of the party in default. In that case the liquidated damages clause could be treated as an exemption clause, and subject to the legal restrictions regarding exemption clauses, should be given effect accordingly.

Regarding the second situation whereby the amount of liquidated damages is greater than the actual loss caused by the breach, the issue is how to determine whether the amount of liquidated damages is "excessively higher" than the actual loss within the meaning of Article 114 of the CL. It has been suggested by learned authors⁶ that the excessive character of the liquidated damages should be determined in the light of the actual loss, the difficulties of proof of actual loss, and the wilfulness of the breach. It was suggested that a proper test would be to ask whether the amount of the liquidated damages is evidently unfair or unconscionable. The

CL has already adopted the unconscionability test to investigate the validity of a contract. Nonetheless, investigations on the unconscionability of a liquidated damages clause should focus on the circumstances of the making of the contract, as well as the circumstances of the breach after the conclusion of the contract, whereas investigations on the unconscionability of the validity of a contract should be limited to the circumstances existing at the time of the conclusion of the contract.

Under the Common Law tradition, one would turn to case laws for further relevant principles, which would be binding or persuasive to other Courts facing similar issues. However, under the laws of the Mainland, case laws would have no such binding or persuasive effects. Nonetheless, this article will examine two relevant decisions. Although both decisions were made prior to the implementation of the CL, they could be useful in providing guidelines and could be used as examples for future reference.

Shan Chuan Machine Bed Moulding Factory (山川機床鑄造廠) ("Shan Chuan") v Qing Hai Province Xing Da Project Construction Holdings Company(青海省興達工程建設集團公司)("Xing Da")

In 1991, Shan Chuan signed an agreement with Xing Da whereby Shan Chuan leased 5 trucks to Xing Da for the purposes of soil removal in Shenzhen. The duration of the lease agreement was one year, and the annual rental for the trucks was RMB 800,000.00, ie the monthly rental was RMB 66,666.67. There were provisions in the leasing agreement regarding liquidated damages. Unfortunately the case report did not provide details of the provisions. In any event, Xing Da failed to pay the rental, and Shan Chuan exercised its rights to terminate the leasing agreement and repossessed the trucks. Further, Shan Chuan commenced legal proceedings against Xing Da at the Xi Ning City Intermediary People's Court for, inter alia, outstanding rental at RMB 266,666.68, liquidated damages at RMB 40,000.00, and other miscellaneous charges.

⁵ Article 21(5) of the Regulations provides if the contractor "fails to provide the product or fails to complete the works, the contractor should pay liquidated damages in the sum of 10% to 30% of the value of the non-provided product or incomplete works or parts thereof, or 20% to 60% of the contract price." Whereas if the employer "terminates the contract, in the case of the contractor providing the raw materials, the employer should pay liquidated damages being 10% to 30% of the price of the unused raw materials; in the case of the employer providing the raw materials, the employer should pay liquidated damages being 20% to 60% of the unperformed contract price." According to an Explanation given by the Supreme People's Court dated 21 July 1987, agreements on liquidated damages within the above range are valid. Parts of the agreements outside the above range are invalid. If the agreement is lower than the minimum of the range, the minimum range will be applicable.

⁶ Contrast this with Article 20 of the FECL, which stated that "Monies for breaching contract agreed in a contract are deemed to be compensatory damages for breaching a contract."

⁷ See for example Bing Ning, *Contract Law in China*, 2002 edition, Hong Kong: Sweet & Maxwell.

Xing Da's defence was that there was a serious spring flood in Shenzhen which was not seen in 30 years. The flood was unforeseeable, unavoidable and insurmountable, and as such Xing Da should not be liable.

The Xi Ning City Intermediary People's Court handed down its judgment in October 1992. It was held that the lease agreement was valid. The Court upheld Shan Chuan's repossession of the trucks and its claim for unpaid rental. The Court awarded to Shan Chuan outstanding rental at RMB 266,666.68 plus miscellaneous charges. However, the Court took into account the adverse weather in considering the liquidated damages clause. The Court decided to exercise its discretion and excluded the liquidated damages.

Xing Da then appealed to the Qing Hai Province High Court. In a judgment handed down in May 1993, the Appellant Court took the view that the Court below has correctly taken into account the change in weather and its effects on the income, and has correctly exercised its discretion in excluding the liquidated damages. Accordingly, the Appellant Court dismissed Xing Da's appeal. One main consideration was that Shan Chuan's actual loss being the loss in income etc has been fully compensated, and given Xing Da's practical difficulty in performing the works, the Appellant Court supported the decision of the Court below to exclude the liquidated damages.

Thus the Courts' approach appeared to be that the Courts would exclude liquidated damages if:

- the aggrieved party's loss has been fully compensated, and
- circumstances have arisen which are beyond the control of the party in default.

While it is relevant under the CL to investigate whether the aggrieved party's loss has been fully compensated, the factor regarding the extraneous circumstances, whether they were beyond the control of the party in default or not, should not be taken into account under the CL.

He Gang City Industrial and Agricultural District Hua Lian Decoration Company (鶴崗市工農區華聯裝飾公司) ("Hua Lian") v He Gang City Asia Shopping Centre (鶴崗市亞細亞商場) ("Asia Shopping Centre")

In 1992, Hua Lian entered into an agreement with Asia Shopping Centre whereby Hua Lian leased a counter in the shopping centre from Asia Shopping Centre. The duration of the lease was 5 years. The annual rental was RMB 38,000.00, and the total rental for 5 years was RMB 190,000.00, which was payable in 3 installments. The first installment in the sum of RMB 64,000.00 had been paid by Hua Lian in January 1993. The second installment in the sum

of RMB 63,000.00 was payable in January 1994, and the third installment in the sum of RMB 63,000.00 was payable in January 1995. One of clauses in the lease agreement provided that the goods sold by Asia Shopping Centre in its own centre must not duplicate those goods sold by Hua Lian.

The agreement also provided that should any party breach the agreement, the party in breach would pay liquidated damages in the sum of RMB 100,000.00.

In January 1993, Hua Lian discovered that some of the goods sold by Asia Shopping Centre duplicated with those goods sold by Hua Lian. Despite repeated demands by Hua Lian, Asia Shopping Centre continued to sell those goods. Accordingly, in May 1993, Hua Lian commenced legal proceedings in the People's Court of Agricultural and Industrial District of He Gang City, demanding Asia Shopping Centre to remove the duplicated products and demanding payment of liquidated damages in the sum of RMB 100,000.00.

In a judgment handed down in October 1993, the People's Court of Agricultural and Industrial District of He Gang City confirmed that the lease agreement was valid and that Asia Shopping Centre was liable to pay damages. In the course of the hearing Hua Lian acknowledged that the duration of the lease agreement was quite long, and Hua Lian was prepared to accept liquidated damages in the sum of RMB 76,000.00. However, Asia Shopping Centre still refused to pay the reduced sum of liquidated damages. The Court supported Hua Lian's assessment and ordered Asia Shopping Centre to pay Hua Lian liquidated damages in the sum of RMB 76,000.00. However, the Court ordered that Hua Lian should use part of the sum of RMB 76,000.00 to set off the second installment in the sum of RMB 63,000.00 payable in January 1994, and the balance of RMB 13,000.00 would be used to set off part of the third installment in the sum of RMB 63,000.00 payable in January 1995.

This decision was then appealed to the Intermediate Court of He Gang City. In a judgment handed down in April 1995, the Appellant Court took the view the liquidated damages in the agreement was too high in the circumstances and should be adjusted. Accordingly, Asia Shopping Centre was ordered to pay Hua Lian RMB 50,000.00, which sum would be used to set off part of the second installment.

It is unfortunate that the report did not set out the reasoning for the Appellant Court to reduce the liquidated damages to RMB 50,000.00. Nonetheless, to readers from a Common Law tradition, it would be surprising that liquidated damages could be used to set off amounts to be paid in the future.