

**The New Economic Reality:
Implications for the Construction Industry in Hong Kong**

**A two-day charity Conference organized by the Civil Engineering
Committee of the
Hong Kong Construction Association**

28th and 29th Oct 2009

Level 3, JW Marriott Hong Kong, Pacific Place

88 Queensway, Hong Kong

Security for Payment

Neil Kaplan CBE QC SBSⁱ

THE NEW ECONOMIC REALITY, IMPLICATIONS FOR THE CONSTRUCTION INDUSTRY IN HONG KONG.

Neil Kaplan CBE QC SBSⁱⁱ

SECURITY FOR PAYMENT

It is an inconvenient truth that disputes in all walks of life are inevitable and none more so than in the construction industry. It may not be so sad for the dispute resolvers, be they lawyers, engineers, surveyors, architects or accountants, but it is surely sad, inconvenient and damaging for the parties. As we all know disputes take time to resolve and the costs and delay involved in traditional dispute resolution mechanisms, namely litigation and arbitration, can be crippling and, in addition, commercial relationships can be damaged and that is unhelpful, to say the least, in the present economic climate.

Over the years there has been a growing resistance to using a Rolls Royce system when it is now acknowledged that a Toyota Yaris gets you from A to B just as swiftly and far more economically.

Perhaps I should begin by asking why are there disputes? In my judgment the main reason is that language is not as precise a tool in the legal context as it may be in the literary sense. In a recent best-seller entitled *Eats, Shoots and Leaves*, author Lynne Truss emphasises the importance of punctuation, the misuse of which can change the meaning of words quite dramatically. The title could refer to the eating habits of a panda or it could equally refer to the actions of a gangster; it all depends where you put the punctuation. Trusse also gives an example from the reign of Henry VIII in the sixteenth century where a popular rhyme went like this

*“Every lady in this land
hath twenty nails on each hand.*

*Five and twenty on hands and feet
and this is true ,without deceit.”*

How different it reads when you put the full stop after nails.

“Every lady in the land has twenty nails. On each hand, five; and twenty on hands and feet.”

Punctuation is not the only problem. It is not always easy to encapsulate in contractual language what it is the businessman desires to achieve. Furthermore, the contract drafter cannot foresee everything that might occur which requires to be covered by contractual language.

Furthermore, contract drafters cannot guard against disputed versions of facts anymore than they can guard against sheer intransigence of view.

We should not be under any illusions. Disputes have been with us from time immemorial and some of the methods used to deal with them, which some think are new, have been with us just as long. Arbitration was practised by the Greeks and Romans and prior to that. Arbitration was the subject of case law and academic debate in the Middle Ages in England and many of the topics we discuss at conferences and seminars today were on the table for discussion then too.

We tend to think that the events of the last thirty years in Hong Kong have evidenced a revolution in dispute resolution. But arbitration has been established as a prime dispute resolution mechanism for millennia. We hail the advent of mediation in Hong Kong as a new process but it is nothing more than a resurgence of a process that has equally ancient antecedents as arbitration.

Let me take you back to the age of Louis XIV in France in the seventeenth century. Thanks to the excellent research of Professor Derek Roebuck, formerly dean of the City University Law School in Hong Kong, long lost writings of a Frenchman called La Roche but known as the Prior of St. Pierre have been discovered and translated into English. This work which was published in the sixteenth century is addressed to the King and the other organs of government.

In 1668 La Roche presented his book to King Louis XIV which he entitled "*The Charitable Arbitrator*". The front page states:

"to prevent suits and disputes or at least to finish them quickly without trouble or cost."

He would have been an ideal candidate for a post with the Hong Kong Contractor's Association!

This gem of a book was discovered and translated by Professor Roebuck whose introduction to the period states:

"La Roche had a bee in his bonnet. He is determined to do something about what he considers France's worst failing: chicanery. Litigation is everywhere, passionate and never ending. It ruins rich and poor alike.....La Roche knows the answer; arbitration."

At the beginning of the book there is a letter addressed to the King:

"to succeed in that (putting an end to disputes) they (the King's illustrious ancestors) judged it more useful for the people and easier for the prince if they forbade suits and disputes, or at least finished them off at birth, rather than requiring the judges to judge them well and promptly. Those good princes thought that nearly all of those who had suits or disputes would rather come to an agreement; or at least one of the two would want to; to wit, the weakest or wisest but he would not dare to show it for fear of what actually happens, that his opponent or his side would draw back and boast that he was afraid. What would happen, if they had intermediaries or mutual friends, is that the one who wanted peace would first give

his word and the other would find it hard to accept because of the respect and deference he felt for the mediators.”

Here La Roche goes on to add that just as wars are ended by mediation of other kings so “*in the same way lawsuits of ordinary people.... could be ended in the same way*”.

So I suppose this proves, if proof were necessary, that there is probably nothing new under the sun!

The importance of this passage is that it emphasises the need for speedy resolution of disputes. It is this feature of the techniques of dispute resolution upon which I want to concentrate in this paper.

When I first started to practise in this field in Hong Kong, firstly for government and then for non- governmental parties, we were very much exercised with the doctrine of substantial completion. This was because this was and, to an extent, still is the contractual touchstone for the commencement of arbitration. I can recall cases where arbitrations were commenced and then the employer argued that as substantial completion had not been achieved the arbitrator had no jurisdiction to hear the case. This sometimes led to a hearing to decide whether completion had been substantially completed. It is probably this mind set which has acted as a disincentive to substantial and radical change.

Today we see an array of different mechanisms in place, all of which have a common feature. That common feature is the ability to decide the case, or part of a case, at a stage far earlier than before.

Before looking at these mechanisms let us draw a clear distinction between Final and Preliminary Procedures. They can best be explained by the following table:

- A. Final Determination Procedures
 - (i) Court litigation;
 - (ii) Arbitration;
 - (iii) Expert Determination

- B. Preliminary Determination Procedures
 - (i) Mediation;
 - (ii) Early Neutral Evaluation
 - (iii) Adjudication;
 - (iv) Dispute Review Boards/Panels

By final determination we mean a process which is binding finally upon the parties. This can be either a court judgment which is enforceable under the rules of court or it can mean an arbitral award which can be enforced under the Arbitration Ordinance as if it were a judgment of the court. Or it can be an expert determination which is contractually binding and thus will be enforced by the court as a contract. Either of these procedures can be resorted to by reason of the contractual agreement of the parties and it is open to the parties to agree when they can be resorted to e.g only after substantial completion.

By preliminary procedures we mean those procedures that can be used at any time during the pendency of the contract. In most of these cases the decision of the dispute resolver although contractually binding and, as we will see, enforceable, can be reviewed in a subsequent arbitration.

Mediation can be mandated in the contract or it can be agreed to as a mechanism whenever the parties so agree. It can be used whenever agreed. However the point of mediation is that a third party facilitates the parties to come to an agreed settlement of the dispute (or part of it). Usually this leads to a new agreement which is itself contractually binding in the event of non-performance.

Early Neutral Evaluation involves a preliminary assessment of the issues in dispute. This evaluation is designed to serve as a basis for further negotiations and to avoid unnecessary stages in litigation or arbitration. The parties appoint an independent and respected person to give an unbiased evaluation of the parties relative strengths and weaknesses and guidance as to how that person sees the matter being resolved if it goes to a full merits hearing.

Let us now look at some of these features in the context of timing, with the caveat that each case depends on its own contractual provisions but bearing in mind that we are most often talking in this context of standard form contracts, conditions or rules.

Mediation

Mediation burst on the scene in Hong Kong in the mid -1980s as a response by contractors to the delays and costs inherent in litigation and arbitration. There was natural scepticism at first but I think now all would agree that mediation - although not the eternal panacea - is certainly a useful method in appropriate cases and great success has been achieved by its use. If it is used early and if it works, then it does save costs, time and aggravation. However, a mediation started too early may fail as a result of one of the parties not yet understanding the issues sufficiently well to reach an informed decision. Sometimes it may not be appropriate to use it until later in the dispute when much of the cost has been incurred.

To avoid the argument that our friend from France referred to it has struck me how useful contractually mandated mediation can be. Today in court systems, in many jurisdictions,

judges are referring parties to mediation. In some jurisdictions, like Germany, it is the duty of the judge to attempt to settle the case.

Often the question is asked whether arbitrators should encourage mediation. This is a difficult question because they are appointed and paid to decide the case. In these days when mediation is so well known in so many walks of life it is a little naive of arbitrators to think that mediation has not been considered by the parties' legal representatives either because they suggested it themselves or the client demanded it. On balance I am not in favour of arbitrators jumping into the settlement arena; they should keep their powder dry to do what they have been appointed to do.

Mediation like arbitration can only be embarked upon if the parties agree to it. They may agree to it in their contract or they may agree to it once their dispute arises or at any time thereafter. If it is commenced earlier rather than later and if it results in a settlement the advantages are obvious. Do not forget that it can be and often is used after an award on liability has been rendered either to prevent an appeal or to resolve undecided issues of quantum. Also do not forget that it can be used to resolve discrete issues which may arise while leaving other issues to a different mechanism.

One feature of the Airport Core Programme contract was that it contractually mandated mediation thus obviating the argument that one party asserts to the effect that going to mediation is a sign of weakness. La Roche got that right over 350 years ago! To make mediation a condition of going to the next stage, whatever that might be, is in my view a wholly salutary process.

So the conclusion on mediation is that it may have the result of assisting the settlement at an early stage but it all depends when it is used. Making it a condition of going to the next stage of dispute resolution is in my view wholly beneficial. When used late it may have less benefit. When it fails the costs are technically wasted but the process might have been useful in

highlighting points leading to a better understanding of the relative positions, which may of itself lead to a settlement. Mediation can, of course, be used again at a later stage.

Dispute Review Boards

As you will recall the airport project enabled a number of different processes to be utilised. For the airport site itself there was set up a Dispute Review Group of seven appointed experts and a legal Convenor. Dispute Review Boards seem to have emanated from the USA.

The earliest reported use was on Boundary Dam in Washington in the 1960's, where the technical "*Joint Consulting Board*" was asked to continue its operation and make decisions regarding conflicts. The idea worked well and the seed was sown. In 1972, a study was undertaken in the U.S. by the National Committee on Tunnelling Technology into improved contracting practices. This resulted in a 1974 publication "*Better Contracting for Underground Construction*" which, amongst other things, highlighted the undesirable consequences of claims, disputes and litigation. In the wake of this report a DRB was established in 1975 for the Eisenhower Tunnels in Colorado and this became an example that has been followed enthusiastically since then in the U.S.A.

The DRB concept received a boost in 1990 when the World Bank published "*Procurement of Works*" which comprised amongst other things a modified FIDIC contract with provisions for DRBs' non-binding recommendations.

In 2000, the World Bank produced a new edition of this study which signified a shift away from the U.S. model of DRBs towards the FIDIC Dispute Adjudication Board (DABs). Thus where the World Bank has adopted a FIDIC contract the DABs give a decision which is a more binding approach to the resolution of the dispute. By contract the parties must comply with such a decision without delay as soon as they receive it. If a party expresses his dissatisfaction with the decision within the stated time period, it may submit the dispute to a final resolution by arbitration, if the parties have so agreed, or, if not, the courts. The parties,

however, remain contractually bound to comply with the decision unless and until the arbitral tribunal or the court rules otherwise. If neither party expresses dissatisfaction with a decision within the stated time period, the parties are contractually bound to honour the decision. I have noted that some think that once a Notice of Dissatisfaction (NOD) has been served that in some way turns what has been agreed to be a binding Decision into a non-binding one. I think this argument fails to appreciate the difference between binding and final. A Decision can be binding in the sense that it has to be honoured but it may not be final in the sense that it can be varied subsequently by an arbitral award. Under the FIDIC Conditions (1999 edition) it is clear that the Decision becomes final when upheld or varied by the arbitrator or when the time for commencing an arbitration has expired. Whatever the position the Decision is always binding and thus can be enforced notwithstanding the request for arbitration. If this were not the case then the mere issuing of a NOD would deprive the Decision of any effect and permit the challenging party to delay matters for as long as it could keep the arbitration going. This could not have been the intention of the drafters.

A study undertaken by the Florida Department of Transport has concluded that contracts lasting longer than one year with a DRB had less cost and time overruns than comparable contracts without DRBs.

The Dispute Resolution Foundation has conducted research that indicates that over 98% of disputes referred to dispute boards conclude the matter, Of the 2% referred to arbitration or litigation over 50% result in the Decision being upheld.

The experience in Australia and New Zealand matches that of USA. This year at least A\$1 billion worth of contracts started with DRBs. However since 1987 the number of disputes formally referred to a DRB has been less than 4. All disputes in the 20 contracts with DRBs since 1987 have been resolved within the structure of the DRB thus avoiding arbitration and litigation.

There are different formats for DRBs. This is not surprising in that that the Dispute Review Board Federation estimates that by 2007 well over 1,350 projects had been completed or were undergoing construction utilising DRBs. The total value of the projects involved is estimated at US\$ 140 billion. There is a very large list of countries where DRBs have been utilised including US, UK, France, Ireland, Sweden, Denmark, Italy, Switzerland, Turkey, South Africa, India, Pakistan and China. DRBs are in place for the projects for London's Olympic Games of 2010.

There are varied models for DRBs and DABs but the one that I know and support is the one where the Board members are engaged for the likely term of the project and are contractually bound to visit the site say every 3 months. During these visits they have a detailed inspection of the progress of the works and they attend the opening and closing sessions of the quarterly review meetings attended by the top people on both sides.

In addition to these regular visits any three members of the Board may be appointed by the Convenor to decide any disputes referred to the Board. This allows early resolution of disputes subject to reference to arbitration.

Peter Chapman (a member of the HK Airport DRB) in an article entitled "*Dispute Boards on Major Infrastructure Projects*" summarises the pros and cons of the non-binding recommendation and the interim binding decision in the following terms:

"The non-binding recommendation

Pros:

- *Often helps parties to resolve a dispute by virtue of the advice the recommendation gives so long as the parties have respect for both the standing and competence of the DB members.*
- *Swings and Roundabouts approach.*

- *Cultural backgrounds may be of influence; e.g. in China the tradition of conciliation will often lead to the adoption by the parties of the DB recommendation, thereby avoiding further conflict.*
- *Non-threatening process.*
- *Less hearing preparation effort required.*
- *Shorter hearings.*
- *Simpler hearings.*
- *Hearing costs reduced*
- *Experienced parties are very often able to resolve matters based on a DB recommendation alone.*
- *In the U.S.A. the non-binding recommendation, which normally extends only as far as matters of entitlement and not quantum, generally finds acceptance because neither side is usually eager to pursue the matter through arbitration or the courts.*

Cons:

- *Enable the losing party to postpone the day of reckoning merely by giving the required notice of arbitration.*
- *The recommendation may be ignored by the 'losing' party without any contractual powers of enforcement.*

The Interim binding decision

Pros:

- *If necessary, may be enforced by legal processes (enforcement may not be without difficulty, depending on jurisdiction).*
- *The binding nature of the decision will focus the minds of the parties during the dispute resolution process, and can thus lead to early settlement.*

- *The binding nature of the decision is unlikely to be ignored even by an unwilling or an impecunious party (breach of contract).*
- *In a joint venture consensus may be difficult insofar as adopting a recommendation – this is not so with a decision.*
- *Eases situations in jurisdictions where corruption and suspicion may be aroused if any public employee authorises payments that are not absolutely compulsory.*

Cons:

- *Matters often harder fought as there is more to play for.*
- *Hearing preparation costs, hearing time and costs are likely to be more. Generally more documentation is put before the DB.*
- *Higher chance of legal representation.*
- *Final decision taken away from the parties.*
- *Some matters are very complex, and the time limits can be testing when much rests on the decision.”*

Adjudication

Professor Doug Jones, the 2011 President of the Chartered Institute of Arbitrators, stated in a paper last April delivered to the American Bar Association;

“A knowledge of history makes one very cautious about proclaiming a revolution in construction dispute resolution. The difficulty and the cost (both the time and money) of resolving construction disputes has been persistent and universal. New ideas on how to manage this have been legion, and the magic bullet has not been found.

However, with the impact made internationally by contractual adjudication and by statutory adjudication in the UK and Australia over the last decade, it is sorely tempting to think that something in the nature of a revolution might be taking place. Without a doubt, something quite significant is happening.”

When we use the term “*adjudication*” we usually refer to the statutory regimes for adjudication which we see in the UK, Australia, New Zealand and Singapore. It should be recalled that contractual adjudication existed well before the statutory code and was designed to address the same evils, namely, the problems that sub-contractors experience in obtaining periodic cash flow. However the bargaining power of main contractors and employers (including Government) ensured that such provisions were rarely agreed.

In the UK after the Latham Report the Government introduced the statutory code that now exists. Other jurisdictions followed suit. In order to prevent adjudication clauses from being deleted by employers and main contractors it had to be made compulsory.

At the heart of the UK code we find two forms of relief which were designed to address the concerns of sub-contractors.

- (1) The protection of periodic payment cashflow; and
- (2) A ban on “*pay when paid*” clauses.

In addition to the above the legislation provides for a very fast-track procedure so that the sub-contractor can obtain speedy relief.

Thus far we see that legislation has dealt with the problems associated with periodic payments/pay when paid clauses as well as speedy resolution of the adjudication process. But bearing mind that the adjudicator’s decision is contractual and cannot be enforced as an arbitral award a third feature was required to make the system work. That third feature was the ever important role of the court. As my colleague Dr Robert Gaitskell QC has put it in his lectures at Kings College, London;

“However this alone would have been insufficient, if the English court system had not been sufficiently robust to enforce adjudication decisions in the teeth of the multiple challenges that were immediately mounted against them. If the court system had failed to supply this

robust support for adjudication decisions then the legislation itself would have achieved little, since virtually every adjudication decision would have been challenged in one way or another. The fact that adjudication has become a runaway success, and transformed the nature of dispute resolution in the construction industry, is thanks largely to one man [the then judge in charge of the Technology and Construction Court (TCC)]”

By deciding in a few early cases that, save in the most exceptional circumstances, decisions of adjudicators would be enforced by the courts summarily i.e without need for a full hearing, adjudication achieved what its promoters intended namely, a very early, speedy and summarily enforceable decision.

However it must be remembered that whatever decision the adjudicator arrives at it is still subject to challenge in a subsequent arbitration. The difference is that if the sub-contractor wins the adjudication he receives the money there and then even if it turns out later that he is owed less or in fact owes money to the main contractor.

How is the system working in practice in UK? Well the most obvious effect has been the virtual demise of domestic construction arbitration. 11 years ago the leading set of construction chambers in London handled no adjudication. Today one third of all its work is devoted to adjudication. This may be as adjudicator, as advocate in adjudications or as counsel in court proceedings relating to adjudications. Furthermore, anecdotal evidence suggests that approximately 90% of all disputes end after the adjudication and no further proceedings ensue.

Has this affected the work load of the TCC? It most certainly has. In 1995 the TCC handled 1778 new cases and in 1996 1500. By 2004 this had reduced to 390. This was in a large part due to the growing popularity and effectiveness of adjudication.

So the efficacy of adjudication depended on how the courts were going to deal with enforcement issues. Were they going to refuse enforcement when a party to adjudication expressed dissatisfaction with the decision and referred the matter to arbitration or were they going to keep parties to their bargain by enforcing decisions thus requiring payment immediately and leaving it to the arbitration to decide whether any repayment is due? Fortunately for contractors the courts in England took the latter course. This was in line with earlier case law relating to decisions of experts where the courts lay down that they would be enforced as a contract unless something very serious went wrong, like an expert answering the wrong question or acting dishonestly.

So what has happened in effect is that the legislation has shifted the risk of delay in payment from contractor to employer and from sub-contractor to contractor. This helps to keep contractors and sub- contractors in business. Shortly I will consider whether this development has had any effect on the remainder of the project.

I have thus far referred mainly to the UK experience but similar developments have taken place in other common law jurisdictions like Australia, New Zealand and Singapore. It is interesting to observe that in those jurisdictions "*Pay when paid*" provisions are rendered of no effect, though the precise definition of these types of clauses varies from Act to Act (Victorian Act, s 13; Queensland Act, s 16; WA Act, s 9; NZ Act, s 13; Singapore Act, clause 9.)

- *Victoria* (under the *Building and Construction Industry Security of Payment Act 2002*, supplemented by the *Building and Construction Industry Security of Payment (Amendment) Act 2006*);
- *Queensland* (under the *Building and Construction Industry Payments Act 2004*);
- *Western Australia* (under the *Construction Contracts Act 2004*);
- *Northern Territory of Australia* (under the *Construction Contracts (Security of Payments) Act 2004*);
- *New Zealand* (under the *Construction Contracts Act 2002*) ("**NZ act**"); and

- *Singapore* (under the *Building and Construction Industry Security of Payment Act 2004*) ("**Singapore Act**")

Despite all of the above, adjudication in Hong Kong is only available on a consensual basis. I think this a great shame. I can see nothing in the special circumstances of Hong Kong that justifies it taking a different course to the other jurisdictions I have mentioned. Accordingly I would favour a compulsory statutory scheme.

I should add at this point that HKIAC issued Adjudication Rules in 2007 and has set up a Panel of Adjudicators having set out the guidelines for inclusion on such panel. A course has been held and those successful were included on the panel. Rule 58 of the HKIAC rules provide that the Decision shall be rendered within 56 days unless the parties, after the dispute has arisen, agree to a longer period.

Some argue that consensual arbitration is satisfactory because if parties require a quick binding decision they can have a "*fast track*" arbitration. The problem with that is that it is still an arbitration and any award is final and binding. Because of that I have noticed a marked reluctance by parties to give up their procedural rights in favour of speed. That is not to say it does not sometimes occur but it is fairly rare. Furthermore most of the fast track arbitrations I have come across have not been construction disputes. Accordingly I do not think that the possibility of a fast track arbitration is any answer to the need for a statutory scheme for adjudication. Of course there will be some parties who pride themselves on their record in dealing fairly and expeditiously with claims and thus may oppose a statutory scheme. But it is necessary to look at the bigger picture and realise that the need for a scheme exists in order for fairness and justice across the board as well as an incentive for finishing the works in an atmosphere of cooperation as opposed to confrontation.

Conclusion

Let me conclude by summarising what I believe are the immense advantages of an early binding dispute resolution mechanism albeit one that can be reviewed in a subsequent arbitration.

1. Disputes that are nipped in the bud do not fester and infect the remainder of the project;
2. Disputes that linger can often encourage other but non related disputes;
3. An early settlement of disputes preserves relationships;
4. An early settlement of disputes prevents the need for protracted correspondence and claims building;
5. An early resolution can be achieved when the place or item of dispute is still viewable and available;
6. An early resolution will take place when those with knowledge about the dispute are still around and available to assist the dispute resolver;
7. A dispute which is delayed until after the works have been completed can lead to arbitration with crucial witnesses unavailable or unwilling to assist;
8. Late dispute resolution requires reliance on memory of events that may have happened years ago. This often leads to reliance on contemporary documents which may have been created with the dispute in mind;

9. Early resolution provides much needed cash flow and assists in keeping businesses afloat and workers paid;

10. The cost of early resolution through adjudication is certainly far less than a full blown arbitration after the work has been completed;

11. Finally the early resolution of disputes must have a beneficial effect on the remainder of the project by removing the poison that disputes inevitably generate.

I applaud the HKCA for arranging this timely conference which raises crucial issues affecting an important industry in Hong Kong. A judge once said “*Law reform – are not things bad enough already?*” But today I think we have a more positive attitude to improving systems which for years we have taken somewhat for granted. Thus with apologies to President Obama, the time may well have come for change.

I would like to recognise the assistance I have derived from the work of 3 esteemed colleagues; Peter Chapman, barrister, arbitrator and DRB member for his paper entitled “*Dispute Boards on Major Infrastructure Projects*” Professor Doug Jones, partner, Clayton Utz, Australia for his paper entitled “*A New Frontier: Using Innovative Construction ADR Techniques in Other Commercial Sectors*” and Dr. Robert Gaitskell QC of Keating Chambers, London, arbitrator, adjudicator and advocate for his lectures at King College, London on “*International Statutory Adjudication*”

I would like to recognise the assistance I have derived from the work of 3 esteemed colleagues; Peter Chapman, barrister, arbitrator and DRB member for his paper entitled “*Dispute Boards on Major Infrastructure Projects*” Professor Doug Jones, partner, Clayton Utz, Australia for his paper entitled “*A New Frontier: Using Innovative Construction ADR Techniques in Other Commercial Sectors*” and Dr. Robert Gaitskell QC of Keating Chambers, London, arbitrator, adjudicator and advocate for his lectures at King College, London on “*International Statutory Adjudication*”