

Enforceability of “Remaining Fee Clauses”

Introduction

“Remaining fee clauses” are common in maintenance, equipment rental or subscription service contracts. Briefly, these clauses provide that if a contract is terminated prematurely, a service user would still be liable to pay the service fees for the unexpired term. The amount of the aggregate fees can be quite substantial depending on the length of the unexpired term. This continuous liability to pay can create enormous financial pressure on businesses already suffering from cashflow problems: a common occurrence in a number of industries hardest hit by the COVID19 pandemic such as the food and beverages and the travel industries. This article discusses the enforceability of remaining fee clauses and offers some tips to practitioners who are advising on such matters.

Authorities on the enforceability of “remaining fee clauses”

The authorities on the enforceability of “remaining fee clauses” have remained unsettled. In *Fuji Xerox (Hong Kong) Ltd v Vigers Hong Kong Ltd* (HCA3753/2003), the dispute arose out of a printers’ rental agreement with a typical “remaining fee clause” which provides that, upon premature termination of the agreement, the service user should pay the total service fees for the unexpired term to the service provider. The service user sought to terminate the contract prematurely but such attempt was rejected by the service provider who sued for the remaining service fees under the “remaining fee clause”. At the Court of First Instance, the service user argued that the “remaining fee clause” is a penalty clause. The court disagreed, and held that the same was not a penalty clause, having regard to the fact that there was no second-hand market for the rented photocopiers and there was indeed a loss of earnings by the service provider in respect of the early termination of the contract. The decision was upheld by the Court of Appeal.

A diametrically different decision was arrived at by the District Court in *Ricoh Hong Kong Ltd v Maxwin Digital Printing Ltd* (DCCJ 3032/2006) which bore a similar factual matrix. In this case, the Court distinguished the facts of the *Fuji Xerox* case and noted that it had great reservation about the plaintiff’s argument that there was no second-hand market for the photocopiers. Further, the Court relied on the presumption (as held in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79) that a clause would be a penalty clause if it provided for payment of a single lump sum “on the occurrence of one or more or all of several events, some of which may occasion serious and others but trifling damage”. In the circumstances, and having regard to the nature of the “remaining fee clause” providing for payment of all the rental fees irrespective of when the defendant terminated the agreement, the court held that the “remaining fee clause” was a penalty clause.

A slightly more recent case on the issue of enforceability of “remaining fee clause” is *Tai Chok Man v TVB Pay Vision Ltd* (HCSA 9/2009). This case is concerned with a contract for subscription to TV channel. The subscriber entered into an 18-month contract with the TV channel provider. When the subscriber sought to terminate the contract early, the TV channel provider demanded payment for the remaining service fees for the unexpired term. Notably, the contract itself did not contain any provision to allow the subscriber to terminate the contract before expiry of the term. The subscriber paid as demanded but subsequently sought to recover the fees so paid from the TV channel provider at the Small Claims Tribunal. The learned Adjudicator held that he saw nothing wrong about the “remaining fee clause”. In the subscriber’s appeal to the Court of First Instance, the Court sided with the learned Adjudicator and upheld his decision, on the basis that (1) the subscriber breached the contract by seeking to terminate the contract prematurely (as there is no provision to allow the subscriber to do so) and (2) the TV channel provider was thus entitled to demand the subscriber who terminated the contract prematurely to pay such sums as were payable for the rest of the contract period as damages for the breach. Thus, the Court held that the “remaining fee clause” was not a penalty clause.

Recent development of the rule on penalty clauses

The above three Hong Kong cases all applied the traditional rule on penalty clauses (as held in the *Dunlop Pneumatic Tyre Co Ltd* case) that hinges on whether the agreed sum is a “genuine pre-estimate of loss”. Such rule has, however, been reformulated by the UK Supreme Court in *Cavendish Square Holding BV v Makdessi* and *ParkingEye Ltd v Beavis* [2015] UKSC 67. In this landmark decision, the Supreme Court held that the true test is whether the clause mandating payment by the defaulting party is out of proportion to the innocent party seeking to enforce such clause, and the Court is entitled to take into account broader consideration which goes beyond the issue of compensation.

The Hong Kong Court has only recently adopted the new test in *Cavendish Square*. In *Bank of China (Hong Kong) Ltd v Eddy Technology Co Ltd* [2019] HKCA 339, the issue in dispute was whether a clause providing for the lender retrospectively to charge default interest which the lender agreed to waive in light of a previous settlement with the borrower was a penalty clause. For the first time, the Hong Kong Court of Appeal applied the *Cavendish Square* test and upheld the enforceability of the said clause, on the basis that there was nothing penal for the lender to revert to its full rights as it had been expressly provided for under the default clause, and that the borrowers showed no evidence that the default rates are “extravagant, exorbitant or unconscionable”.

In *Dragon Access Holdings Ltd v Lo Chu Hung* [2020] HKCFI 2895, the issue in dispute is whether a clause under a preliminary sale and purchase agreement in a property sale stipulating that the vendor was liable to pay a sum which doubled the initial deposit should it fail to proceed to completion was a penalty clause. The Hon Queenie Au-Yeung J applied the *Cavendish Square* test following the Court of Appeal’s decision in *Bank of China (Hong Kong) Ltd v Eddy Technology Co Ltd* [2019] HKCA 339 and held

that the clause was not a penalty, because the buyer did have a legitimate interest in the completion of the sale and the said compensation was neither “exorbitant nor unconscionable” in nature to justify judicial intervention.

In a more recent decision in *Center (76) Ltd v Victory Serviced Office (HK) Ltd* [2020] HKCFI 2881, which was decided only on 19 November 2020, one of the issues in dispute was whether a clause under a tenancy agreement providing that the landlord might recover the rent during the three months’ rent-free period in the event of the tenant’s default is a penalty clause. DHCJ To further elaborated the principles as decided in the *Cavendish Square* case:

1. First, whether a contractual provision is a penalty is a question of interpretation of the contract and the real question is whether it is penal or punitive in nature.
2. Second, a penalty clause exists where a secondary obligation is imposed upon a breach of a primary obligation owed by one party to the other. It is to be distinguished from a conditional primary obligation, which depends on events that do not constitute breaches of contract.
3. Third, whether a clause imposes a secondary liability upon a breach of contract is a question of substance and not of form.
4. Fourth, a provision that in substance imposes a secondary liability for breach of a primary obligation is penal if it imposes on the party in default a detriment which is out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation (or using traditional language, which is exorbitant, extravagant or unconscionable).
5. Fifth, the onus lies on the party alleging that a clause is a penalty clause. Thus, the three essential elements of a penalty clause are:

(1) that it imposes a secondary obligation upon breach of a primary obligation;

(2) that the secondary liability imposes a detriment on the party in breach; and

(3) that the detriment is out of all proportion to the legitimate interest of the innocent party in the enforcement of the primary obligation.

The Court held that the clause in dispute did not impose a secondary obligation and even assuming that it did, the legitimate interest of the landlord (i.e. to ensure observance of the terms of tenancy agreement by the tenant) outweighed the detriment to be suffered by the tenant (i.e. to pay three months’ rent). It follows that the clause was not a penalty clause.

Analysis on the enforceability of “remaining fee clauses”

As alluded to above, the Hong Kong courts, whilst applying the reformulated rule, have not completely discarded the traditional rule on penalty clauses (i.e. whether the agreed loss is “exorbitant, extravagant or unconscionable”). It follows that the pre-*Cavendish Square Holding BV* authorities continue to be relevant.

In our view, depending on the facts of each case “remaining fee clauses” may or may not be regarded as penalty clauses.

Factors suggesting they are not penalty clauses

1. There is only one obligation to pay the fees which continue to be due and payable so long as the service user performs its obligation under the contract.
2. Even though the clause can be triggered by a trivial breach, the service user may be afforded an opportunity to rectify the breach (sometimes an agreement may contain a built-in relief from the penalty by allowing the service user to rectify the breach after receiving notice of breach from the service provider).
3. The service provider may not be able to sell or rent out the second-hand products (if the models are too old).
4. The fees are for the unexpired term of contract, which the service user would have been liable to pay had the contract not terminated.

Factors suggesting they are penalty clauses

1. The liability to pay is triggered only by the breach of the contract only.
2. The obligation to pay concerns fees for the unexpired term.
3. The service user has no legal right to use the service or possess the products after termination of the contract, whilst the service user needs to bear the service fee for the unexpired term of the contract.
4. The clause can be triggered even for trivial breach.
5. The service user is in effect paying the service provider for nothing in return (because, as alluded to above, the service would have been suspended by that time).

Tips for practitioners

For practitioners advising the service provider, it is advisable to adopt the following non-exhaustive precautionary measures:

1. taking client’ s instructions on what their legitimate interest in the “remaining fee clauses” are and how such clauses can be commercially justified;
2. structuring, as far as possible, the “remaining fee clauses” as primary obligations (although the Cavendish Square case expressly provides that the court will look beyond the stipulation of the contract to see whether the clause imposes a primary or secondary obligation or not);
3. providing certain built-in relief from the penalty to the effect of requiring the service provider to give a notice of breach (in the case of occurrence of a breach) and allowing the service user certain time thereafter to rectify the same;
4. maintaining proper records (both oral and written) of negotiations between the parties leading up to execution of the contract.

For those advising the service user, they may wish to consider adopting the following non-exhaustive precautionary measures:

1. limiting the scope of any triggering event for the “remaining fee clauses” as far as possible;
2. adding some exceptions to the triggering of the “remaining fee clauses” ;
3. inserting a proper termination clause for the service user to be added to the contract itself.

(This article was first published in the June 2021 issue of the Hong Kong Lawyer, the official journal of The Law Society of Hong Kong.)

2021-06-17