

LEGISLATIVE COUNCIL BRIEF

REFINEMENTS TO THE PILOT SCHEME FOR ARBITRATION ON LAND PREMIUM

INTRODUCTION

At the meeting of the Executive Council on 31 March 2020, the Council **ADVISED** and the Chief Executive **ORDERED** that –

- (a) the amount of premium payable by the applicant upon completion of arbitration under the Pilot Scheme for Arbitration on Land Premium (Pilot Scheme) should not go beyond the upper and lower limits set on the basis of the last premium offers made by the Lands Department (LandsD) and the applicant respectively before the arbitration process starts; and
- (b) with the refinement as proposed above and other fine-tuning measures (as set out in paragraphs 15 - 20 below), the Pilot Scheme should be extended for two more years until 23 October 2022.

JUSTIFICATIONS

Background of the Pilot Scheme

2. Private (re)development through lease modification / land exchange has been a key source of land supply for housing and other uses. Lease modification / land exchange is a matter of contract between a developer (applicant) and LandsD acting in the private capacity of a landlord, and is concluded by negotiation and mutual agreement. The amount of premium payable is one of the key terms of such contracts, and the time needed to reach agreement on this could significantly prolong the negotiation process.

3. To provide an additional avenue for both developers and LandsD to expedite the conclusion of land premium negotiations, hence speeding up land supply for housing and other uses, the Chief Executive announced in the 2014 Policy Address the introduction of the Pilot Scheme, with the objective of encouraging the use of arbitration, a consensual dispute resolution process, to resolve the disagreement over premium payable. Under the Pilot Scheme, an independent Arbitral Tribunal will decide on the level of premium payable, and the outcome will be binding on both parties. The Pilot Scheme was launched in October 2014 for an initial trial period of two years, and was twice extended in 2016 and 2018 until October 2020.

4. So far, the response to the Pilot Scheme has been lukewarm. As of May 2020, LandsD has proactively issued a total of 33 counts of invitations to arbitration under the Pilot

Scheme in respect of 16 lease modification / land exchange applications, among which only one case has proceeded to arbitration.

5. It is difficult to identify a definitive explanation for the lukewarm response. In general, for developers to enter into arbitration, which commits parties to accept whatever level of premium as decided by the Arbitral Tribunal, involves risks. This contrasts with the normal premium negotiation process where the developer retains certain control over the timing of concluding the negotiation and the premium payable at that point in time, with the choice not to accept LandsD's premium offers. Of the feedback we have received on the Pilot Scheme, one of the most cited concerns is the risk of the premium in the arbitral award being even higher than LandsD's premium offer made during premium negotiation (known as Binding Basic Terms Offer (BBTO)¹).

6. In order to promote the use of the Pilot Scheme with a view to boosting land supply, the Chief Executive-in-Council endorsed the setting of upper and lower limits for the amount of premium payable for cases under the Pilot Scheme.

Upper and Lower Limits on Premium Payable

7. The upper and lower limits will be set and agreed by the applicant and the Government **prior to** the commencement of the arbitration process, setting a range for the premium payable, in the following ways:

- (a) if the amount eventually awarded by the Arbitral Tribunal is within the upper and lower limits, the premium payable will be the amount awarded by the Arbitral Tribunal;
- (b) if the amount eventually awarded by the Arbitral Tribunal is higher than the upper limit, the premium payable will be the upper limit; and
- (c) if the amount eventually awarded by the Arbitral Tribunal is lower than the lower limit, the premium payable will be the lower limit.

8. The upper limit will be the premium offered by LandsD in its last BBTO **prior to** the signing of the Arbitration Agreement. After one appeal on the premium by the applicant², both sides may invite the other to settle the premium negotiation by arbitration under the Pilot Scheme. If the other side indicates **in-principle agreement** (at this point the Arbitration Agreement has not been signed), LandsD would issue one more BBTO (with a premium offer) to the applicant, alongside a proposed Arbitration Agreement for acceptance. If the applicant decides to accept and sign the Arbitration Agreement at this point³, the premium offered by

¹ BBTO is an offer of terms made by LandsD to the applicant for land transactions (including lease modification, land exchange, private treaty grant, etc.) which includes the amount of premium payable. The acceptance of the BBTO by the applicant will constitute a binding contract between LandsD and the applicant.

² The triggering threshold of the Pilot Scheme would be lowered from two rounds of premium appeal to one appeal. See paragraphs 15 and 16.

³ At this point, the applicant may also decide to accept LandsD's premium offer, which will conclude the negotiation, or to continue the normal negotiation process without resort to arbitration.

LandsD in the last BBTO will become the upper limit for premium payable for the purpose of the Pilot Scheme⁴.

9. The lower limit will be the last counter-offer made by the applicant in its last premium appeal, **before** either party extends an invitation to the other to settle the premium negotiation by arbitration under the Pilot Scheme.

10. A flowchart showing the setting of the upper and lower limits in the context of the activation of the arbitration procedure is at **Annex A**.

11. No adjustments to the upper and lower limits will be allowed after the Arbitration Agreement is signed. This is necessary for the purpose of providing certainty to parties to arbitration.

12. In order not to affect the Arbitral Tribunal's independent judgement on the arbitral award, the upper and lower limits would not be disclosed to the Arbitral Tribunal. In other words, the Arbitral Tribunal will be at liberty to decide on any award it finds appropriate with its independent assessment, including an award which goes beyond the upper or lower limit, but if it does go beyond either of the limits, the pre-agreed arrangement in paragraph 7 will apply.

13. The following considerations have been taken into account in setting upper and lower limits on premium payable –

- (a) the possibility of an arbitral award going beyond LandsD's last premium offer, though remote, does represent a risk to, hence disincentive for, the applicants. Removing this disincentive could help encourage more cases to come forward, hence avoiding prolonged idling of precious land resources and speeding up land supply, and at the same time facilitating the Government and the real estate sector to build up experience in settling premium through arbitration;
- (b) there might be questions as to whether the setting of upper limits would mean revenue forgone for the Government in the event that the arbitral award does exceed the upper limit. However, such discussions would be academic as without the pre-set limits, it is uncertain whether the applicant would enter into arbitration in the first place and whether any agreement could ever be reached if normal premium negotiation goes on. And arguably, the playing field is level as there is also a chance of the arbitral award going below the lower limit;
- (c) there might be concerns as to whether the last offer of the applicant would be too low, leading to an unreasonable lower limit. First, it should be noted that arbitration is a consensual process, and both parties have full discretion to decide whether to enter into arbitration, or continue with the conventional premium negotiation. Moreover, the lower limit would apply only if the Arbitral Tribunal sets an award at a level even lower than the lower limit. But if the Arbitral Tribunal does give such a ruling, it would mean that the lower limit is in fact not "too low"; and

⁴ The applicant would need to sign both the Arbitration Agreement as well as an Acceptance Letter for arbitration which would give effect to the upper and lower limits arrangement.

- (d) setting out the upper and lower limits would not tinker with the proceedings and jurisdictions of the Arbitral Tribunal, since we are not confining the rulings of the Arbitral Tribunal to those limits. In other words, the Arbitral Tribunal will adjudicate the premium payable in the same way as it does under the current mechanism, in an independent and impartial manner based on the evidence and arguments presented by both sides, without knowing the upper and lower limits. This will enable us to gather information to understand whether the arbitral awards are often within the range of the upper and lower limits, or if they often exceed such limits. In the latter case, which is unlikely, we can further review and adjust the arrangement to better protect the Government's interests.

Other Fine-tuning Measures

14. In addition to the setting of upper and lower limits on premium payable, taking into account the experience so far and stakeholders' views, we will introduce the following fine-tuning measures to improve the operation of the Pilot Scheme.

(i) Lowering Triggering Threshold

15. Currently, both the applicants and the Government may propose for the other party's agreement to settle the premium negotiation by arbitration when both parties fail to agree on a premium figure "*normally after at least two appeals by the Applicant*". This triggering threshold is set since it would be premature to accept that there are unresolved disputes before substantive exchange by both parties.

16. While it is necessary to maintain a triggering threshold in order to allow exchanges of views before resorting to arbitration, the triggering threshold will be **lowered** from the current two appeals to **only one appeal** so that both sides may have earlier access to the Pilot Scheme. A complete removal of the triggering threshold would not be conducive to the arbitration process which requires both parties to agree on a list of specific issues in dispute, which would then be adjudicated by the Arbitral Tribunal.

(ii) Allowing Submission to Comment on the Other Party's Case

17. In the only completed Pilot Scheme case in 2015, after the submission of the valuation reports to the Arbitral Tribunal by the Government and the applicant, the Arbitral Tribunal directed both parties to make a written submission to comment on the other party's valuation report. This process is considered useful as it provided an opportunity for both parties to draw the Arbitral Tribunal's attention to particular issues contained in the other side's valuation report which might not otherwise be noticed by the Arbitral Tribunal. We will therefore make it a standard step in the arbitration procedure for the Government and the applicant to make a submission commenting on the other party's valuation report. Timing wise, with the experience of the 2015 case, a period of two weeks is considered appropriate for both parties to prepare such submissions. With this new requirement, the Arbitral Tribunal is expected to hand down the award within 12 weeks after the formation of the Arbitral Tribunal (instead of 10 weeks under the existing framework).

(iii) Enriching LandsD’s “Information Note”

18. To assist the industry in understanding the operation of the Pilot Scheme, LandsD has published an “*Information Note relating to the Pilot Scheme for Arbitration on Land Premium*” (Information Note).

19. There are merits of providing more information to the industry to facilitate their consideration of using the Pilot Scheme. At the same time, it is important to ensure the disclosure would not become a deterrent to potential applicants who wish to maintain the confidential nature of arbitration in the same manner as the premium negotiation process.

20. We will enrich the Information Note with reference to the completed cases under the Pilot Scheme on a case by case basis, bearing in mind the concern for confidentiality. For example, the enriched Information Note may include location of the lot and lot number of completed cases, the composition of the Arbitral Tribunals appointed, the actual time taken for the arbitration process and the amounts of premium payable, etc. The additional information would assist potential users of the Pilot Scheme in deciding how arbitration under the Pilot Scheme may help their own cases.

Revised Implementation Framework

21. Taking into account the refinements, we have revised the implementation framework of the Pilot Scheme last promulgated in 2014. The revised framework together with the indicative flowchart is at **Annex B** (with the revisions reflecting the latest refinements underlined).

B

Implementation Timetable

22. Following the decision of the Chief Executive-in-Council in March 2020, we have revised the relevant documents under the Pilot Scheme (such as the standard Arbitration Agreement). We aim to implement the refinements to the Pilot Scheme beginning from early August 2020. To allow time to accumulate experience, the current Pilot Scheme, which was set to expire on 23 October 2020, will continue to run on a trial basis for two more years up to 23 October 2022.

IMPLICATIONS OF THE PROPOSAL

23. The implications are set out at **Annex C**.

C

PUBLIC CONSULTATION

24. We consulted the relevant stakeholders⁵ before launching the Pilot Scheme in 2014. In putting forward the above-mentioned measures, we have taken into account comments and suggestions made by the stakeholders after the launch of the Scheme. The Land and Development Advisory Committee was briefed on the refinement measures on 7 July 2020. Members recognised the setting of upper and lower limits on premium payable under the Pilot Scheme as a worthy step to incentivise the use of arbitration to resolve disagreement over premium payable for lease modification and land exchange applications to expedite land supply.

PUBLICITY

25. Briefings will be arranged to assist the industry and other stakeholders in understanding the refinements to the Pilot Scheme before implementation. An information note on the refined Pilot Scheme will be uploaded to LandsD's website.

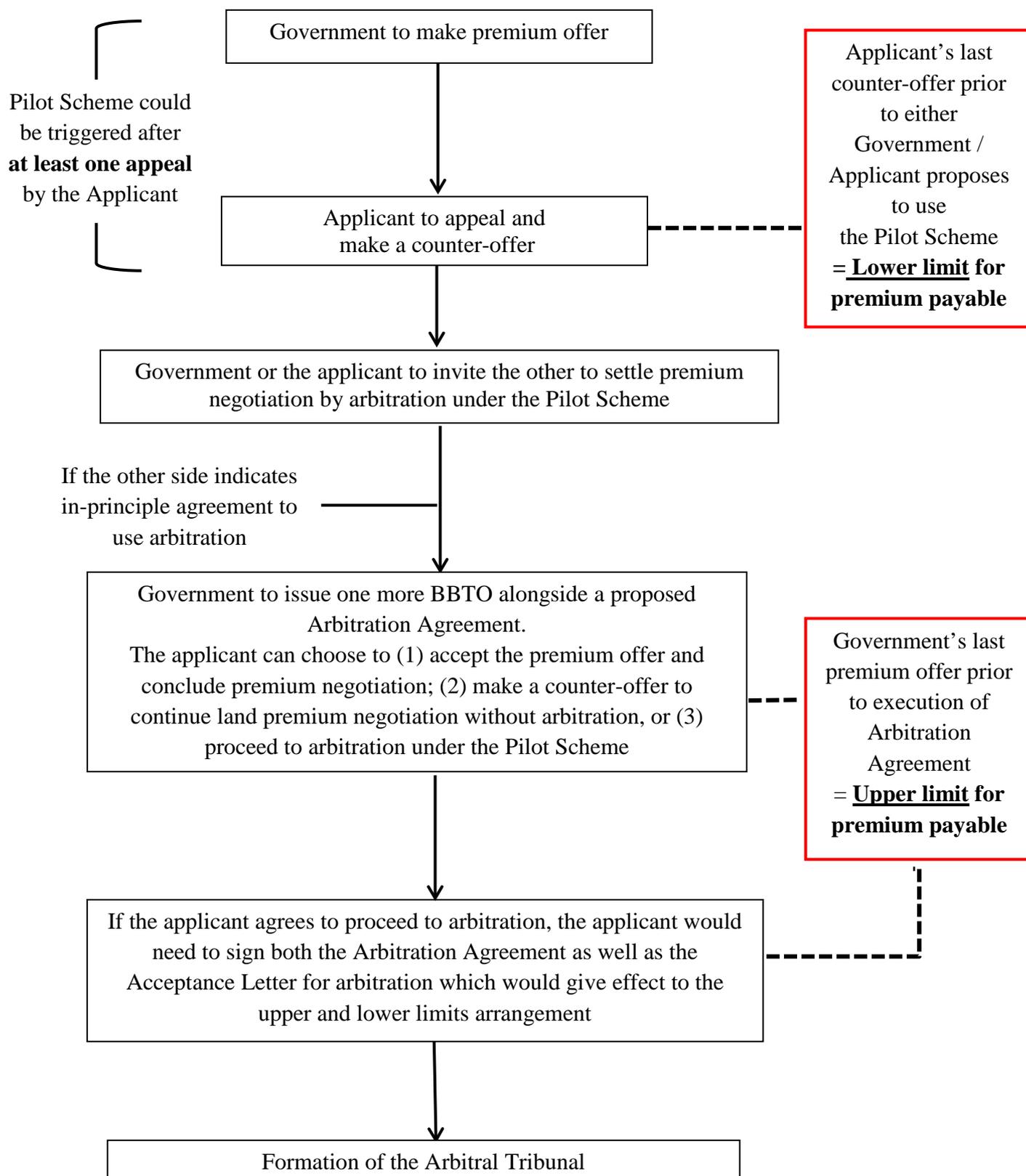
ENQUIRIES

26. Enquiries relating to this brief can be directed to Mr Raymond Wu, Principal Assistant Secretary for Development (Planning and Lands) at 3509 8804.

Development Bureau
17 July 2020

⁵ They included the Lands Sub-committee of the Land and Development Advisory Committee, the Hong Kong Institute of Surveyors, Royal Institution of Chartered Surveyors, the Real Estate Developers Association of Hong Kong, Hong Kong Bar Association, the Law Society of Hong Kong, Hong Kong International Arbitration Centre, Hong Kong Institute of Arbitrators and the Hong Kong Mediation and Arbitration Centre.

Indicative Flowchart on the Setting of Upper and Lower Limits for Premium Payable under the Pilot Scheme



Revised Implementation Framework of the Pilot Scheme

The revised implementation framework of the Pilot Scheme is as follows:

(A) When Arbitration may be Triggered

Either the lease modification / land exchange applicant or LandsD may propose for the other party's agreement settling the premium negotiation by arbitration when both parties fail to agree on a premium figure *after one appeal* by the applicant.

(B) Case Prioritisation and Selection Criteria

If upon reaching the trigger point in (A) above, many applicants express readiness to enter into arbitration and this overall demand exceeds the capacity of relevant departments and the arbitrator-candidates in handling multiple arbitration cases at the same time, higher priority may be given to –

1. “high yield” cases in terms of net increase in flat number (e.g. not less than 200) or net gain in non-residential gross floor area (e.g. not less than 20,000m²);
2. cases with a wider premium gap; and
3. cases with fewer or more straightforward issues in dispute.

(C) Scope of Arbitration

The subject to be arbitrated should be confined to the amount of premium.

(D) Appointment of Arbitral Tribunal

The Arbitral Tribunal will comprise three arbitrators, with the President nominated and agreed by the Government and the applicant. For the other two members, the Government and the applicant would each nominate one valuation professional who would be subject to the other party's agreement.

(E) Measures to Guard Against the Applicant “Walking Away”

If the applicant backs out during the arbitration proceedings (i.e. after execution of the Arbitration Agreement) or fails to execute the lease modification / land exchange at the premium as arbitrated, *or at the upper limit or lower limit if the arbitral award falls beyond the range*, the 15% of the premium last assessed by the Government being the deposit will be forfeited. A restriction on alienation of the subject lot or transfer of shareholding (in case the applicant is a company) will also be imposed to deter against the applicant “walking away”.

(F) Arbitration Timeframe

The valuation date will be fixed as at the date when the Arbitral Tribunal is first constituted. The Tribunal should hand down the award *in around 12 weeks* after its constitution (*including two weeks for both parties to make a submission commenting on the other side's valuation report after the submission of their respective valuation report to the Tribunal*). Under normal circumstances, a “documents only” procedure shall be adopted and there shall be no oral hearing. An indicative flowchart is at **Appendix**.

(G) Premium Payable

An upper limit and a lower limit on the premium payable in respect of each case handled under the Pilot Scheme will be set and agreed by both parties, prior to the commencement of the arbitration process.

The upper limit will be the last premium offered by LandsD prior to the signing of the Arbitration Agreement. The lower limit will be the last counter-offer made by the applicant in its last premium appeal, before either party invites the other to use arbitration under the Pilot Scheme. The upper and lower limits will not be disclosed to the Arbitral Tribunal.

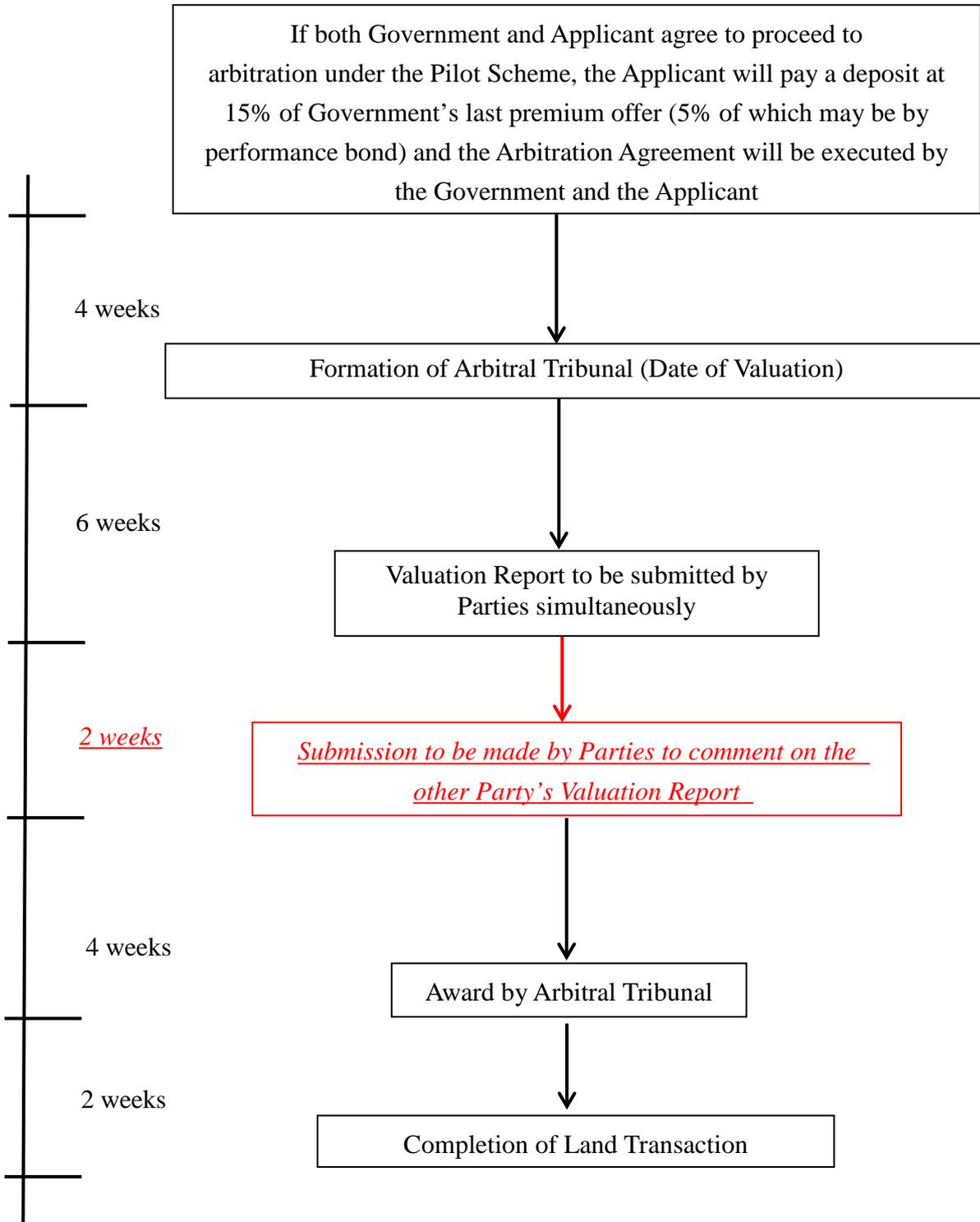
The Arbitral Tribunal has the authority to decide an appropriate arbitral award with its independent assessment, including an award which goes beyond the upper or lower limit.

If the arbitral award is within the upper and lower limits, the premium payable will be the amount awarded by the Arbitral Tribunal. If the arbitral award is higher than the upper limit or lower than the lower limit, the premium payable will be the pre-determined upper or lower limit.

(H) Arbitration Cost

The Government and applicant shall bear its own legal and other costs. The costs of the arbitral proceedings **shall be borne by the parties in equal share** under normal circumstances.

**Indicative Flowchart for Revised Arbitration Procedure
(optimistic estimation for straightforward cases
under “document only” procedure)**



Remarks:

From formation of arbitral tribunal to arbitral award : 12 weeks

Implications of the Refinements to the Pilot Scheme

Basic Law Implications

The refinements to the Pilot Scheme are in conformity with the Basic Law, including the provisions concerning human rights as the Government retains its discretion and control on when and how the Pilot Scheme should be adopted and can choose whether or not to enter into arbitration with its lessees in individual cases.

Financial and Civil Service Implications

2. In the unlikely event that the arbitral award is higher than the upper limit on premium payable, the revenue forgone for the Government is considered notional in nature since the last premium offer, which is the upper limit, had not been accepted by the applicant in the first place. There is no certainty on whether an agreement on premium can eventually be reached if the applicant continues to negotiate with the Government instead of resorting to arbitration under the Pilot Scheme. On the other hand, the setting of a lower limit on premium payable could reduce the risk of the Government in case the arbitral award goes below the last counter-offer made by the applicant.

3. The refinements might attract more applications to the Pilot Scheme which requires extra manpower resources by LandsD and other relevant departments (such as Department of Justice), as well as additional funding for arbitration-related expenses. LandsD has been allocated with additional manpower resources. Other relevant departments would seek additional resources with justifications through the established mechanism should the need arise.

Economic Implications

4. The refinements to the Pilot Scheme should encourage the utilisation of the Pilot Scheme, and might facilitate the whole lease modification/land exchange process, which is conducive to the supply of land for residential and non-residential uses for meeting the relevant socio-economic needs in Hong Kong.

Mainland Relations and Related Public Relations Measures

5. The refinements have no implication on Mainland relations. No related public relations measure is considered necessary.

Other Implications

6. The refinements have no productivity, environmental, competition, family and gender implication. There are no significant sustainability implication, other than the economic implications set out in paragraph 4 above.