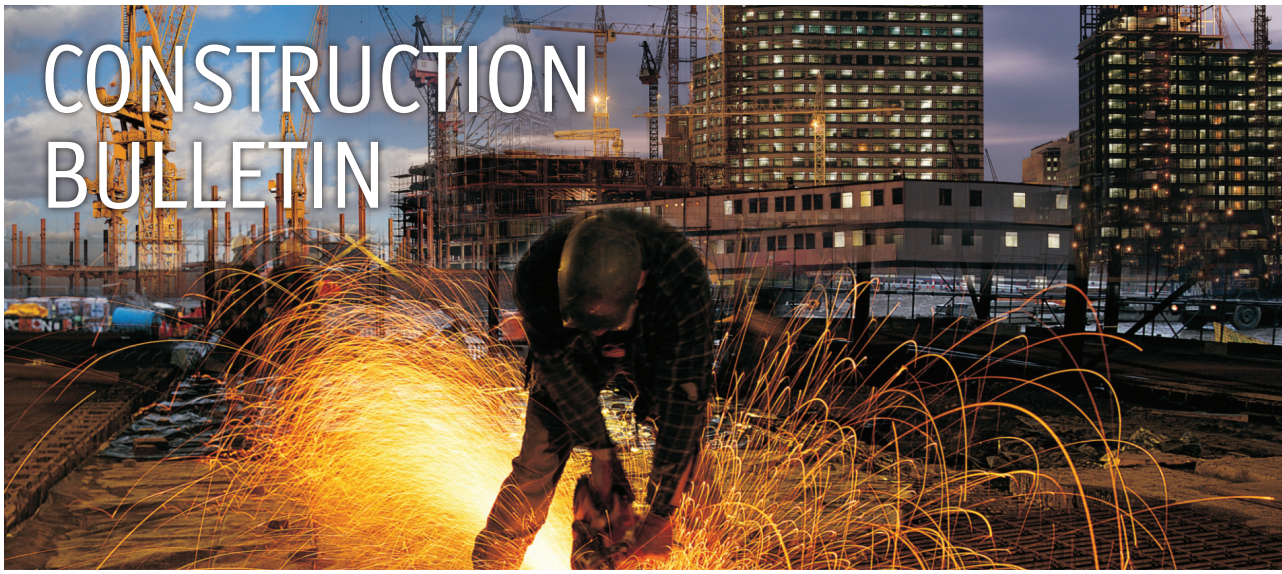
Construction

December 2014

CONSTRUCTION BULLETIN



Welcome to the December edition of our Construction Bulletin.

Over the course of the last few months, HFW has significantly expanded its construction team in Sydney, with the arrival of three new partners, Amanda Davidson, Carolyn Chudleigh and Ian Taylor, along with their respective teams. To mark their arrival, the first two articles in this Bulletin highlight particular issues relating to construction law in Australia.

- **Duties of care for contractors in Australia:** Nick Watts reports on the decision of *Brookfield Multiplex v Owners Corporation* which held that a builder does not owe a duty of care to an owners corporation of apartments for the rectification of latent defects in common property.
- **Consequential loss – the confusion continues:** Gerard Moore considers conflicting decisions in Australian courts regarding the definition of consequential loss.
- **Good faith obligations under NEC3:** Tim Atwood considers how different jurisdictions might interpret NEC3's obligation to act in a spirit of mutual trust and co-operation.
- **Hong Kong Lighthouse Club conference:** Michael Sergeant reports on the Lighthouse Club's 2014 Conference in Hong Kong.

The inside back page of this Bulletin contains a listing of the events at which the members of the HFW construction team will be speaking over the coming months.

Should you require any further information or assistance on any of the issues dealt with here, please do not hesitate to contact any of the contributors to this Bulletin or your usual contact at HFW.

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Duties of care for contractors in Australia

The recent decision of the full bench of the High Court of Australia in *Brookfield Multiplex Ltd v Owners Corporation Strata Plan 61288*[1] unanimously held that a builder does not owe a duty of care to an owners corporation of apartments for the rectification of latent defects in common property.

A critical factor underlying the decision was that the court held that neither the developers, nor the owners corporation were "vulnerable". No duty arose, as the parties had the ability to protect themselves from the risks of latent conditions through the detailed contractual provisions of their respective contracts.

Background

A 22 apartment building was constructed by the builder, Brookfield Multiplex Ltd, pursuant to a design and construct contract (Contract) with the developer, Chelsea Apartments Pty Ltd. The Contract (an AS 4300/1995 form) provided detailed provisions concerning quality, defects liability, insurance and specified standard form sale contracts (which the purchasers entered into with the developer) that required the developer to repair certain defects in the common property.

The building was developed into residential apartments (floors 10 – 22), sold to individual purchasers, and serviced apartments (floors 1 – 9), sold to investors. The case related only to the serviced apartments, as the owners of the residential apartments settled their claims.

Claim

The investor owners of the serviced apartments, via the building's owners corporation, brought an action in negligence against the builder, on the basis that the builder owed it a duty to take reasonable care to avoid reasonably foreseeable economic loss due to rectification as a result of latent defects flowing from defective design or construction.

"No duty arose, as the parties had the ability to protect themselves from the risks of latent conditions through the detailed contractual provisions of their respective contracts."

NICK WATTS, SPECIAL COUNSEL

The claim was brought in negligence, as there was no recourse to statutory warranties under the Home Building Act 1989 and the owners corporation was not a party to the D&C Contract.

It was unanimously held that the builder owed no duty of care to the owners corporation to avoid pure economic loss from latent defects, as that duty only arises in circumstances where the person to whom a duty is owed is of a class of persons who are "vulnerable" to suffering the loss being sued for.

The court held that "vulnerability" in this context was the incapacity of the plaintiff to protect itself from the defendant's conduct and that the ability of a developer, or a subsequent investor purchaser (not including a residential purchaser), to enter into a detailed contract, with the builder or developer respectively, was evidence of an ability to protect oneself via the terms of the contract. Developers and investors are not "vulnerable" persons.

It was further held that the terms of a contract should not be altered by an implied duty in tort, in circumstances where the terms of the contract have been agreed and those terms allocated risk to certain parties which was taken into account by them in the price paid under the contract.

Who is impacted?

Investors purchasing from developers need to ensure they obtain adequate protection from the terms of the purchase contract against losses due to latent defects. This may require accessing and reviewing the terms of the contract between the developer and the builder, to ascertain the scope of any rights/protections regarding latent defects and the obligations to rectify.

As residential purchasers are becoming more sophisticated and, as a consequence, less vulnerable, the current position that builders will owe residential purchasers a duty not to cause loss from latent defects may eventually be eroded.

Purchasers are likely to pursue greater contractual protection against defects. In order to respond to these demands, developers and builders will need to negotiate their respective risk profiles (including latent defects) and "price in" those changes accordingly.

This authority will have an impact for industry and investors, foreign and domestic alike.

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1 [2014] HCA 36

Consequential loss – the confusion continues

Recent court decisions in Australia serve as a warning that the use of broad and undefined terms in exclusion clauses in commercial contracts can have unintended consequences.

Contractual exclusion clauses act to protect parties from the extreme effects of a breach of contract. Often these clauses attempt to exclude liability for broad and undefined categories of loss, such as "consequential loss". The courts on a regular basis are asked to decide what is meant by "consequential loss" and whether an exclusion clause applies.

It is settled law in England that contractual damages fall into two categories. Within the first category are damages which "arise naturally from the breach of contract". The second category is limited to damages which both parties actually knew may arise in the event of a breach. Under English law, consequential losses fall within the second category, although loss of profits is considered a direct loss and is not a consequential loss.

"The debate as to the meaning of the term "consequential loss" in Australia has reached another fork in the road."

GERARD MOORE, ASSOCIATE

The Australian courts in recent years have interpreted "consequential loss" differently and in doing so have caused uncertainty.

In *Environmental Systems v Peerless Holdings*[1], the Victorian Court of Appeal refused to apply the English approach. In that case, Peerless claimed additional labour and energy costs incurred trying to make a regenerative thermal oxidiser supplied by Environmental Systems work satisfactorily.

The court held these costs were "consequential" and excluded by the contract. Interestingly, the court decided the claim on the basis of what a business person would consider consequential loss to mean. The court said:

"... ordinary reasonable business persons would naturally conceive of 'consequential loss' in contract as everything beyond the normal measure of damages, such as profits lost or expenses incurred through breach."

Note that the court distinguished between "normal loss" and "consequential loss". Normal loss was held to be loss that every plaintiff in a like situation would suffer. The court also expressly stated that loss of profits was "consequential loss".

Peerless was applied by the courts in a number of subsequent cases. However, in 2013, the Supreme Court of Western Australia in *Regional Power Corp v Pacific Hydro (No 2)*[2], moved away from the Peerless approach. In that case, Pacific Hydro negligently constructed a hydro power station for Regional Power, resulting in a two-month outage. Regional Power sued Pacific Hydro, claiming damages for its expenses incurred in arranging an alternative power supply during the outage. Pacific Hydro argued that these were "consequential losses" and excluded under the contract.

The court stated that it did not consider that the court in *Peerless* was attempting to establish *"a rigid new construction principle for limitation clauses beyond the present circumstances of that case"*. The court held that the correct approach was to examine the natural and ordinary meaning of the relevant clause in the context of the agreement as a whole and against the commercial context of the contract. The commercial sophistication of the parties, and their understanding that Regional Power had statutory obligations to provide a continuous electricity supply, was also important. The court decided that Regional Power's losses were "direct" in the context of the contract and were not excluded.

The debate as to the meaning of the term "consequential loss" in Australia has reached another fork in the road. Whether the courts will continue to follow *Peerless*, which is a decision of a higher court, or move towards the *Pacific Hydro* approach, remains to be seen.

However the lessons for international commerce are clear. First, contracting parties should not assume that the term "consequential loss" will have the same meaning across different jurisdictions and commercial contexts. Secondly, contracting parties should be specific when drafting exclusion clauses and should not rely on broad undefined exclusions.

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1 [2008] VSCA 26

2 [2013] WASC 356

hfw Good faith obligations under NEC3

Parties to NEC3 contracts must act in a spirit of mutual trust and co-operation. We consider what that means under English law and in other jurisdictions.

The aim of the NEC3 is to nurture a spirit of partnership and fairness between the parties. To that end, there is an express clause in the ECC and PSC contracts, Clause 10.1, which states that:

"The Employer, the Contractor, the Project Manager and the Supervisor shall act as stated in this contract and in a spirit of mutual trust and co-operation".

There are two parts to Clause 10.1. The first is that the parties shall act as stated in the contract, and is self-explanatory.

The second – that the parties shall act in a spirit of mutual trust and co-operation – embodies the NEC's partnering ethos. Its intentions are clear, which might be why it has never been tested in the courts (although the obligation to adjudicate before litigating in Clause W2.4 could be equally responsible), but its wording, and the exact nature of its obligations, is vague.

In an article by Humphrey Lloyd QC in the International Construction Law Review in 2008, he said the obligation is *"…tantamount to one of performance in good faith… The phrase… imports not only honesty and reasonableness but may also oblige someone to do more than the contract calls for if the contract is truly to be performed co-operatively"*.

So it's good faith, honesty, reasonableness, and maybe even a duty to go beyond one's contractual obligations. But how will the English courts apply it? There is no implied duty of good faith at common law, but parties can expressly agree a good faith duty, which is exactly what NEC3 does in Clause 10.1.

Good faith obligations in English law

Back in 1999, *Birse Construction Ltd v St David Ltd* dealt with a mutual trust and co-operation clause in a "partnership charter" that the parties had signed outside the contract. The court recognised that even though the charter wasn't legally binding, it clearly showed how the parties intended to conduct themselves, using examples in the judgment such as taking a sympathetic approach to extension of time claims, and a non-rigid approach to the question of contract formation (which was the issue in dispute). In other words, a clause in a non-binding collateral document could place obligations on how a party could exercise its contractual rights.

If this collaborative approach to interpretation suggests that parties would be expected to compromise their rights, it hasn't lasted. In 2010, *Gold Group v BDW Trading Ltd* confirmed that *"…good faith, whilst requiring the parties to act in a way that will allow the parties to enjoy the anticipated benefits of the contract, does not require either party to give up a freely negotiated financial advantage clearly embedded in the contract"*. In that case, Gold Group was not in breach of an express good faith obligation in refusing to negotiate with BDW to reduce its share of profits in a housing development after the market crashed. Good faith did not mean it had to enter discussions to sacrifice some of its agreed profit.

Then in 2013, two cases demonstrated an even more restrictive approach to express good faith obligations. Both took a strict and technical view of the wording and found the obligations to be restricted to the performance of certain functions. For example, in *Mid Essex Hospital v Compass Group*, the wording of the clause was *"[the parties] will co-operate with each other in good faith and will take all reasonable action as is necessary for the efficient transmission of information and instructions and to enable [Mid Essex] or, as the case may be, the Beneficiary to derive the full benefit of the Contract"*.

The Court of Appeal held (reversing the first instance judgment) that the clause did not impose a general obligation of good faith, but was limited to exercising good faith in *"the efficient transmission of information and instructions"*. A similar decision was reached in *TSG v South Anglia Housing*. In both cases, the court found that the good faith obligation did not impact on the exercise of a party's absolute rights, such as the deduction of performance related sums, or terminating under a termination-at-will clause – which is the same principal as Gold Group.

That said, Clause 10.1 is not restricted in its language, and when we think back to the decision in *Birse Construction*, and the importance placed on the precise wording of the good faith clauses in *Mid Essex and TSG*, as well as recent shifts towards implying good faith duties in certain circumstances, Clause 10.1 in its breadth might indeed *"oblige someone to do more than the contract calls for"*, as Humphrey Lloyd QC suggested.

Indeed in *Willmott Dixon v Newlon Housing Trust*, also in 2013, the court found that a similar obligation in a PPC2000 contract to *"…work together… to achieve transparent and cooperative exchange of information in all matters relating to the Project…"* (which the judge equated to working in mutual co-operation) extended as far



as the dispute resolution clause, which meant that the party on the receiving end of an adjudication had a duty to enquire as to why it hadn't received the right documents from the referring party, rather relying on the defective referral.

However, although it wasn't stated, it is arguable that the obligation in *Willmott Dixon* can be limited in the same way as that in Mid Essex (that it is only applicable to the exchange of information), as the case concerned the exchange of adjudication pleadings.

So, whilst Clause 10.1 should make a party think twice before taking a rigid black letter or potentially unreasonable view on a point, the words of Beatson LJ in *Mid Essex* can be their guide when it comes to express contract rights:

"…care must be taken not to construe a general and potentially open-ended obligation such as an obligation to 'co-operate' or to 'act in good faith' as covering the same ground as other, more specific, provisions, lest it cut across those more specific provisions and any limitations in them".

Good faith obligations in other jurisdictions

NEC3 promotes itself for international use – so how will mutual trust and co-operation be dealt with overseas? Most civil law jurisdictions already impose a good faith obligation on the parties. For instance, Article 148 of the Egyptian Code provides that *"a contract must be performed in accordance with its contents and in compliance with the requirements of good faith"*.

It's not just civil law jurisdictions either – both the USA and Australia recognise an implied duty of good faith. The USA has implied a good faith obligation into every contract since 1917, and it is now incorporated into

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TIM ATWOOD, ASSOCIATE

the Uniform Commercial Code. Even so, its full reach remains unclear, and in 2007 a New York State Court and a US Federal Court were at odds over whether there could be a claim for breach of a good faith obligation, even when there was no other breach of contract – the Federal Court holding that it does not provide a separate cause of action. What is settled though is that in the USA good faith can act to fetter express rights, specifically the right to terminate at will. A party cannot exercise a termination clause in order to obtain a better bargain elsewhere – to do so would be acting in bad faith.

The doctrine of implied good faith in Australia is less certain. There is no definitive High Court decision. Some states have decided in the affirmative (New South Wales and South Australia), other states (Victoria and Tasmania) in the negative, with the others undecided.

A number of approaches have been adopted in Australia to clarify what such a duty means, with a frequently cited approach being that of Sir Anthony Mason, who suggests that good faith in commercial contracts includes the following elements:

- An obligation on the parties to co-operate in achieving the contractual objects (loyalty to the promise itself).
- Compliance with honest standards of conduct.
- Compliance with standards of conduct that are reasonable having regard to the interests of the parties.

However, even where a duty is implied, parties are free to contract out of it, and in NSW the position is that express clauses that endow parties with absolute rights act to exclude any implied duty of good faith. Such clauses giving specific rights to a party would also conflict with an express good faith duty, such as Clause 10.1, with the same outcome.

Conclusion

The full legal effect of Clause 10.1 remains something of a mystery, but parties contracting under English law should be aware of its breadth and should take their duties of trust and co-operation seriously – that is the point behind the NEC after all. Those operating in other jurisdictions which have a recognition, or even a codified obligation, of acting in good faith might expect the reach of Clause 10.1 to go even further.

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Hong Kong Lighthouse Club conference

The Hong Kong Lighthouse Club's annual conference on construction law took place this year on 27 October 2014. It was themed around the subject of variations and two HFW partners, Nick Longley and Michael Sergeant, spoke at the event.

The Lighthouse Club is a construction industry charity which was initially set up in the UK in the 1950's with the aim of giving financial help to the victims of accident and illness within the industry, and their dependants following fatal accidents. The Hong Kong branch was established in 1986 and is a very active fundraiser. The Club's conference on construction law issues is an important event in the annual calendar. The conference was particularly well attended this year, with around 300 delegates from a variety of organisations including employers, contractors, consultants and lawyers.

This year, the conference was themed around the subject of variations. The topic is of particular relevance this year because of the publication of a new book on the subject, called *Construction Contract Variations*, written by two partners within the construction team at Holman Fenwick Willan, Michael Sergeant and Max Wieliczko. The authors' royalties from the book are also being donated to the Lighthouse Club charity.

The speakers at the conference were from a variety of law firms and consultancies based in Hong Kong, including EC Harris, Driver Trett, Pinsent Masons, Hogan Lovells as well as, of course, Holman Fenwick Willan. In addition to the talks on specific topics, the day ended with a lengthy Q&A session, with questions from the delegates being directed to the panel of speakers.

"The conference was particularly well attended this year, with around 300 delegates from a variety of organisations"

MICHAEL SERGEANT, PARTNER

The talks explored the difficulties arising where extra work is required on a construction project, but no formal instruction has been issued and the associated problems in determining the correct extent of the scope of works in the context of a complex technical project. Issues relating to the 3D computerised modelling of projects were also discussed and the extent to which such technology can help reduce the need for variations.

A number of talks focused on issues of particular current relevance to the Hong Kong market. This included an update as to the current position regarding the Security of Payment legislation in Hong Kong, proposals for which include the introduction of an adjudication regime, fixed interim payment requirements and the outlawing of pay when paid provisions. Talks in relation to the valuation of variations included discussion of a number of cases concerning Hong Kong contracts and projects.

Two of the conference talks focused on NEC, a form of contract which is attracting increasing interest in the Hong Kong market. The NEC form of contract treats changes to the scope of works in a radically different way to other, more traditional forms of contract. Firstly, because it treats all contract claims and variations as "Compensation Events" with a single integrated payment regime for both. This approach brings with it enormous benefits, but also some challenges. NEC also has a novel approach to valuing changes to the scope, because it assesses compensation using a schedule of cost components rather than using the traditional contract sum breakdown.

The conference also encompassed discussion on technical issues, with an interesting talk by Alan Donnet of Dragages in relation to the use of Geotechnical Baseline Reports in contracts to provide a baseline from which to assess changes to ground conditions. In particular, how such Reports can be used to assess whether the change is a compensable variation to the predicted scope.

The day was rounded off with a lively debate dealing with many of the key discussion points arising from the talks, with a particular emphasis on valuation issues and the different ways in which the standard form contracts rose to the challenge of valuing work of a type not originally contemplated by the scope.

Special thanks to John Battersby for organising this very successful conference.

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Conferences and events

HFW Offshore Wind Seminar
London
1 December 2014
Presenting: Max Wieliczko, Michael Sergeant and Robert Blundell

FIDIC Middle East Conference
Abu Dhabi
3-4 March 2015
Presenting: Michael Sergeant and Robert Blundell

Australasian Oil & Gas (AOG) Conference
Perth
11–13 March 2015
Presenting: Matthew Blycha

Society of Construction Law
County Durham, UK
17 March 2015
Presenting: Michael Sergeant

HFW Quarterly Construction Seminar
London
18 March 2015
Presenting: Max Wieliczko, Michael Sergeant and Richard Booth

CIArb Hong Kong Centenary Conference
Hong Kong
19–21 March 2015
Presenting: Nick Longley

HFW Breakfast Seminar
Dubai
25 March 2015
Presenting: Robert Blundell and Michael Sergeant

CWC Oil & Gas EPC Conference
Dubai
19–21 May 2015
Presenting: Max Wieliczko, Michael Sergeant and Robert Blundell

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