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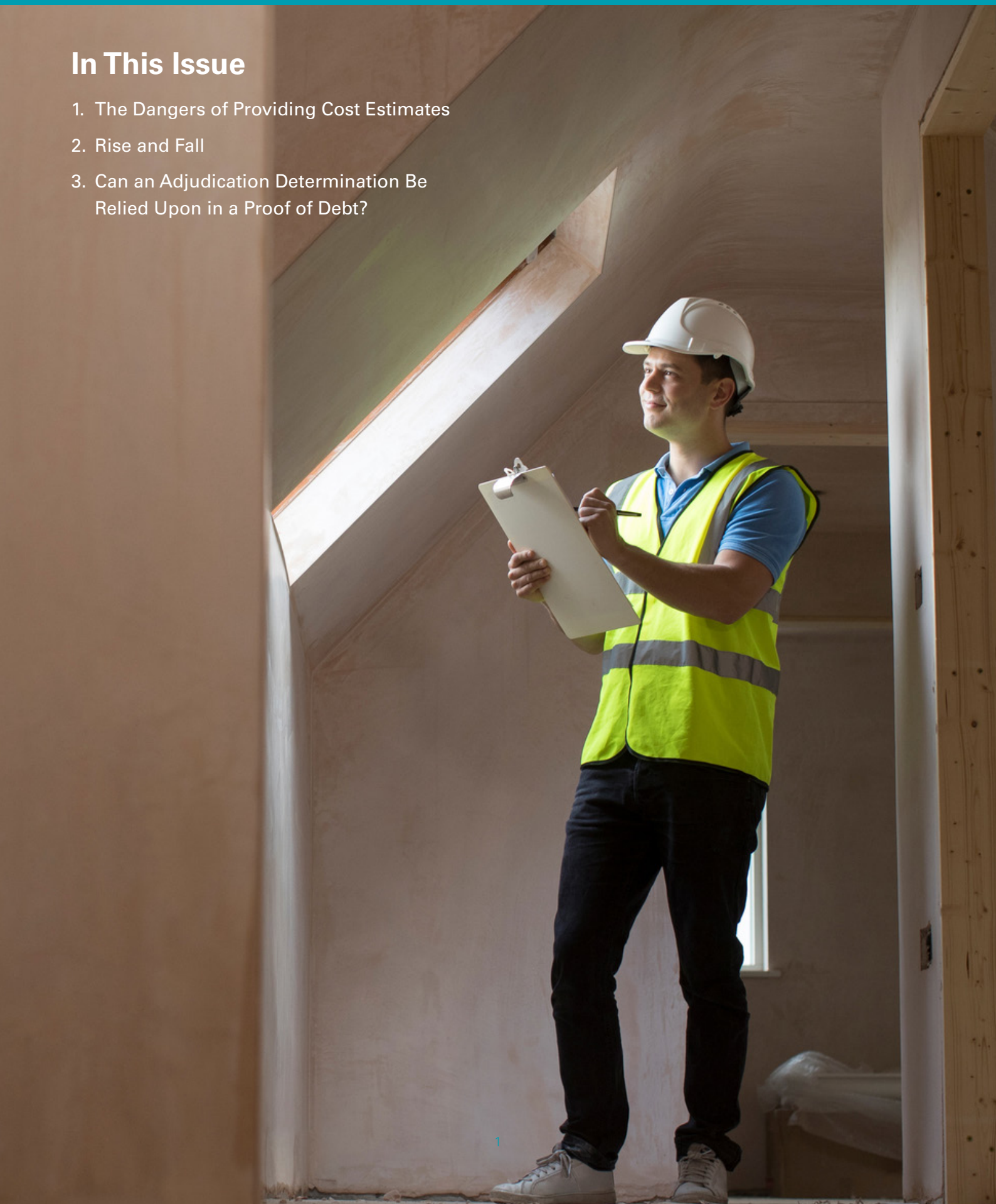


The Dangers of Providing Cost Estimates

Authors – Melissa Koo, Joseph Perkins and Zayna Abu-Geras

In recent years, the cost of construction and building materials has increased in an unprecedented manner, causing more parties to work with cost estimates where a lump sum price cannot be provided or agreed. However, the NSW Court of Appeal's decision in *Morris v Leaney* [2022] NSWCA 95 demonstrates some of the dangers that arise when cost estimates are utilised.

Background

Mr. Leaney, the respondent architect, was engaged to design the home renovations of Mr. and Mrs. Morris, the appellant homeowners. The owners initially informed the architect that their budget was AU$300,000, but the architect advised that the budget was not achievable and provided the owners with a probable cost estimate of AU$590,000, excluding GST and other items. The owners revised their budget to AU$600,000. A builder was engaged on a cost-plus basis and the renovations ultimately cost AU$780,000, but only increased the value of the house by AU$330,000. The owners, among other things, claimed that the architect neglected to advise them as to whether their objectives could be achieved within their budget. The owners sought AU$450,000 in damages from the architect, being the difference between the cost of the building work and the rise in the value of the house as a result of those works.

In the first instance, the primary judge found that the architect had breached his duties under the contract and tort, noting that "if the [architect] felt himself unable or unqualified to give an accurate estimate of costs, he should have warned of that in writing and advised the [owners] to obtain an estimate from a properly qualified professional". Notwithstanding this finding, the primary judge held that the [owners] did not suffer any loss (as there was no evidence that, had the duty been discharged, they would not have pursued the renovations) and only awarded nominal damages.

The two grounds of appeal were:

- Having correctly found that the architect breached the contract and negligently failed to advise the owners about the likely costs of the building, and, in relation to the selection of an appropriate building contract, by permitting the owners to enter into a costs-plus contract with a builder who had not given a price, whether the primary judge erred:
  - In finding that the owners did not suffer any loss
  - In failing to assess the owners' damages on the basis of a "no transaction case"
- Whether the primary judge erred in failing to find that the owners suffered a loss of approximately AU$450,000

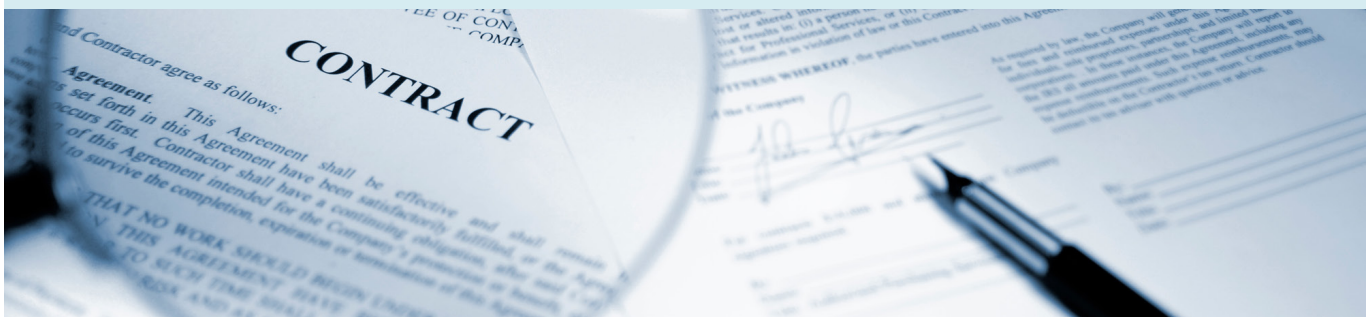
The Court of Appeal found that the primary judge had erred in finding that the owners did not suffer any loss. However, their Honours held that while the primary judge's approach to assessing damages was erroneous, they were unable to conclude on the evidence before them that, had the architect not breached his contractual and tortious obligations, the owners would not have undertaken the renovations. As such, the Court of Appeal rejected the second ground and dismissed the appeal.

Critically, had there been sufficient evidence, the architect would have been liable for the difference between the cost of the building work and the rise in the value of the land. This aspect of the decision is likely to be cause for concern for industry consultants, likely resulting in a greater reluctance to provide cost estimates.

Key Takeaways

Morris v. Leaney serves as a timely warning to architects, and other industry consultants alike, of the inherent risk associated with advising clients on expected or estimated building costs, as well as neglecting to rectify a client's misunderstanding of what may be achieved within their budget. In light of the decision, consultants should consider including terms in their contracts that prohibit reliance on their cost estimates and direct owners to acquire estimates from qualified professionals if they feel unable or unqualified to give an accurate estimate of costs.

If you would like further information on managing price escalation or other risks under your construction contracts, please contact a member of our team. Our commentary on the impacts of inflation and price escalation are discussed in the June edition of our Construction Matters newsletter.



Rise and Fall

Author – Greg Steinepreis

In our June 2022 edition of Construction Matters, we noted a steady increase in interest from project participants on the use of price escalation clauses, driven by COVID-19-related supply chain issues and inflation. We observed that principals and contractors should consider, at the outset, how the risk of cost escalation can be minimised or shared on a project.

There are a number of ways to structure a construction contract to deal with the risk of cost escalation. Cost-plus contracting is being sought more frequently by contractors. Principals who are less keen on paying on a cost-plus basis, and who insist on a lump sum, may have to accept much larger contingency in the present contracting environment. That contingency could be reduced by introducing price flexibility options into the contract. Price flexibility options include allowing for more provisional sums and providing for rise and fall.

Rise-and-fall clauses are making a comeback after decades of absence, when inflation was relatively low and supply chain issues were not acute. Their absence has meant it is necessary for project stakeholders to now reacquaint themselves with the principles behind a workable rise-and-fall clause.

A simple operative rise-and-fall provision would state that the contract sum (or specific rates and prices) will be adjusted for rise and fall in costs as set out in an accompanying schedule. The schedule would contain a description of what aspects of the contract sum are subject to rise and fall, and a formula for the cost adjustment. Usually, the rise-and-fall formula adjusts materials and/or labour costs and is a result of close consultation between quantity surveyors or other technical personnel and legal advisers.

The elements of the rise-and-fall formula will typically involve some consideration of:

- Which components of the contract sum, or which rates and prices in a schedule of rates, are to be adjusted
- Which indices are to be used to measure the price movements, e.g. the Consumer Price Index (CPI) or other indices (such as the Producer Price Indexes, and the labour, Australian materials and imported materials indices) published by the Australian Bureau of Statistics
- Where the adjustment is to a schedule of rates, then if the schedule items are not already appropriately categorised, they may need to be to match the chosen indices
- A risk buffer may be considered, e.g. the first 2% increase is the contractor's risk
- The base date
- The adjustment date
- The period within which movements in cost are to be measured, e.g. monthly or yearly

An example of a formula applying these considerations is Schedule 7 of GC21 (Ed 2), the NSW government's general conditions applicable to public works.

Formulae for rise and fall can be complex, and it is advisable to do worked examples to make sure the formula works as intended. Careful drafting of the narrative aspects of the formula is also recommended, otherwise a disagreement could end up in litigation.

An example of a dispute that went to court regarding the reference dates is a case where it was unclear whether the calculation was to be by reference to the index at the date of tender/contract, or periodically, given the formula allowed for periodic adjustment. [1]

Failure to provide in the contract for alternative indices could lead to the formula being inoperative, with the consequence that no rise–and-fall adjustment can be made. Ambiguous words that allow for flexibility in selecting an alternative index if one is discontinued (such as "the nearest index consistent with the intention of this annexure") may lead to disagreement and litigation.[2]

In conclusion, there is a need for some industry re-education on rise-and-fall provisions, and care should be taken in drafting both the technical and the legal aspects of rise-and-fall clauses.

1 *Lewis Construction (Engineering) Pty Ltd v Southern Electric Authority of Queensland* (1976) 50 ALJR 769; [1975] QSCFC 23. See also *Codelfa Construction Pty Ltd v State Rail Authority of NSW* (1982) 149 CLR 337.

2 For example, *Leighton Contractors Pty Ltd-v- Public Transport Authority of Western Australia* [No 6] [2008] WASC 193. A case where the formula was ambiguous and a key price index was discontinued is *Sino Iron Pty Ltd v Mineralogy Pty Ltd* [2019] WASCA 80, although the formula concerned a royalty.

Can an Adjudication Determination Be Relied Upon in a Proof of Debt?

Authors – Melissa Koo, Joseph Perkins and Joshua Brania

The recent decision *In the matter of Nicolas Criniti Pty Ltd (In Liquidation)* [2022] NSWSC 1149 (*Criniti*) considers the intersection of winding up provisions within the Corporations Act 2001 (Cth)[1] (CA) and adjudication determinations under the Building and Construction Industry Security of Payment Act 1999 (NSW) (SOPA).

Background

The plaintiff builder was engaged by the first defendant, Nicolas Criniti Pty Ltd. (Nicolas), to construct a 27-unit residential block in Sydney. On 17 October 2019, the builder made a payment claim under the SOPA. Nicolas issued a nil payment schedule in response to the claim.

The builder issued an adjudication application under the SOPA. On 22 November 2019, before the adjudication determination was issued, Nicolas appointed the second defendant as voluntary administrator. On 6 December 2019, the adjudicator issued a determination in favour of the builder against Nicolas for AU$927,727.80.

Nicolas was wound up on 24 February 2020, and the builder lodged a proof of debt in the winding up for the amount determined by the adjudicator. The liquidator rejected this on the basis that the builder had not established that there was a valid "statutory debt". The builder's appeal of the liquidator's decision is the subject matter of this case.

Decision

In making his determination, Hammerschlag CJ found that the serving of a payment claim and payment schedule, and the making of an adjudication application, are pre-conditions to an adjudication determination. However, His Honour held that those same preconditions do not give rise to a statutory debt. Rather, it is the adjudicator's determination itself that is the source of the debt.

As the appointment of the voluntary administrator occurred before the adjudicator issued the determination, His Honour dismissed the appeal.

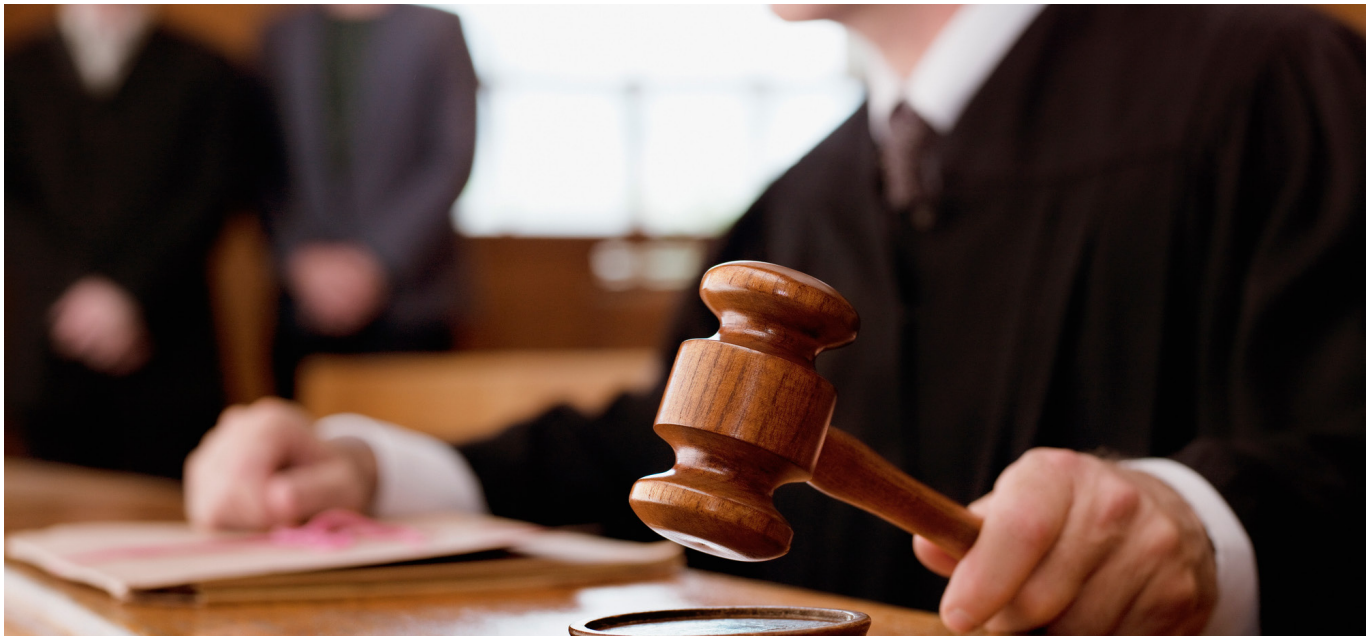
Critically, if the adjudicator's determination were issued before the appointment of the voluntary administrator, the builder would have been able to rely on the determination for the purposes of proving its debt.

Observations

This case illustrates the dangers in applying for adjudication in respect of a claim against a company in financial distress, and provides guidance as to when the matters which are the subject of a payment claim will become a legally enforceable debt in the context of a winding up.

The decision, however, does not obstruct a party's rights under a construction contract and their ability to make claims for the purposes of s 553(1) of the CA.

If you would like further information concerning the adjudication process or enforcing statutory debts, please reach out to a member of our team.



1 See s 553(1) CA.

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