SQUIRE PATTON BOGGS

CONSTRUCTION MATTERS

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Good Faith in AS 11000: Practical Implications for Contractors

Standards Australia has recently released a draft of the AS11000 General Conditions of Contracts (**AS11000**), which is a "construct only" contract, merging AS2124-1992 and AS4000-1997.

Clause 2.1 of the AS11000 introduces a new overriding obligation on parties to act in good faith towards each other; however the AS11000 does not define "good faith", leading some to conclude that the obligation is unclear and may make it difficult for parties to precisely identify its scope. This raises a critical issue for parties who may soon have to deal with the practical implications of this obligation.

Fortunately, the courts have already considered the meaning and scope of an express obligation of good faith. For instance, the NSW Court of Appeal found that a contractual obligation of utmost good faith is to be construed having regard to the terms of the contract and the circumstances known to the parties when the contract was formed. The obligation requires:

- co-operation between the parties to achieve the contractual objects;
- honest standards of conduct;
- reasonable standards of conduct, having regard to the party's interests; and
- parties to have regard to the legitimate interests of the other party but not subordinate their own legitimate interests to the interest of the other contract party.[1]

A further example is the WA Court of Appeal which preferred to adopt the natural and ordinary meaning of "good faith", in finding that the only requirement (in a Memo of Understanding) was for the parties to deal with each other honestly.[2]

The express "good faith" obligation may also have practical implications for the conduct of parties attempting to resolve disputes under AS11000, either at issue resolution meetings (as part of the new early warning procedure), or at conferences convened as part of the dispute resolution procedure.

In that regard, the WA Court of Appeal's comments regarding the obligation to negotiate in good faith appear relevant. Parties may now be expected to:

- actively engage in the conferral process;
- give serious and genuine consideration to proposals and counterproposals made and received;
- make and respond to proposals and counterproposals in a reasonably timely manner having regard to the time allotted for conferrals and to the nature and scope of the issues to be negotiated, their technical and factual complexity, and their commercial significance to the parties; and
- act honestly.

Parties would also be prohibited from conferring in an arbitrary or capricious manner.

For the above reasons, AS11000 may well encourage an effective dispute resolution procedure.

1 *Macquarie International Health Clinic Pty Ltd v Sydney South West Area Health Service*

2 *Strzelecki Holdings Pty Ltd v Cable Sands Pty Ltd [2010] WASCA 222; BC201008728*

The End of "Best Endeavours"

Following the High Court decision in *Electricity Generation Corporation v Woodside Energy Ltd* [2014] HCA, "best endeavours" and "reasonable endeavours" are, in effect, one and the same in terms of the obligation they impose upon a party.

The Facts

Electricity Generation Corporation (t/as Verve) and Woodside were parties to a long term gas supply agreement (the **Agreement**) which obliged Woodside to:

- make available to Verve a proportionate share of a maximum daily quantity of gas;
- use "reasonable endeavours" to make available to Verve a supplemental daily quantity of gas (**SMDQ**); and
- in determining whether Woodside were able to supply the SMDQ, "*take into account all relevant commercial, economic and operational matters…*"

On 3 June 2008 an explosion occurred at a gas plant which caused a decreased supply of natural gas and an increased demand.

Woodside provided the SMDQ to Verve under a new short term arrangement which provided gas to Verve at the prevailing market price, a price far above that which Verve would have paid under the Agreement.

The primary question was whether Woodside had breached the Agreement to use reasonable endeavours to supply the SMDQ by requiring Verve to re tender and enter into a short term agreement for the SMDQ.

The Historical Position

Historically, *Sheffield District Railway Company v Great Central Railway* (1911) 27 TLR 451 has stood as authority for the principle that "best endeavours" equates to "leaving no stone unturned".

The Decision

The High Court held that:

- reasonable endeavours is not an absolute or unconditional obligation.[1]
- what is reasonable will depend on the circumstances, which can include circumstances that may affect an obligee's business.[2]
- an obligation to use reasonable endeavours would not oblige the achievement of a contractual objective *"to the certain ruin of the company or to the utter disregard of the interest of the shareholder"*.[3]
- an obligee's freedom to act in its own business interest in matters to which the agreement relates, is not foreclosed, or sacrificed, by an obligation to use reasonable endeavours to achieve a contractual object.
- best endeavours means those which are objectively reasonable.[4]

The court also held that, unless a contrary intention is indicated, a court is entitled to assume that the parties intended the contract to achieve a "commercial result".

On that basis, the High Court held that the expression "*commercial, economic and operational matters"* (in the Agreement) refers to matters affecting Woodside's business interest; therefore Woodside's ability to supply the SMDQ should be qualified in part by reference to the constraints imposed by commercial and economic considerations.

This had the effect that Woodside were not obliged to forgo or sacrifice their business interests when using reasonable endeavours to make the SMDQ available for delivery. This interpretation was consistent with surrounding circumstances known to both parties at the time of entering into the Agreement.

Take Away Points

We recommend the following factors are considered when drafting or reviewing contract terms:

- Best or reasonable endeavours clauses do not require a party to act in conflict with its own business interests, and do not require that no stone be left unturned to achieve the contractual objective or specific obligation.
- Where a contract includes a best or reasonable endeavours clause, but does not qualify the obligation, the courts will consider what is reasonable in the circumstances having regard to the specifics of the contract and the commercial circumstances in which it was made.
- When drafting contracts importing an obligation of best or reasonable endeavours, be careful to note any other internal standards or qualifications in the contract that may inform or affect the content of the obligation.
- Consider inserting specific and defined criteria to qualify the obligation of best or reasonable endeavours (for instance, a party is entitled to consider its own commercial interests), or, avoid it altogether by the use of measurable standards (e.g. industry standards).

1 *Electricity Generation Corporation (t/as Verve Energy) v Woodside Energy Ltd* [2014] HCA 7 at [41].

2 Ibid [41].

3 Ibid [42].

4 Ibid [56].

A Refresher on Consequential Loss

We are all familiar with clauses which seek to exclude or limit liability for indirect or consequential losses, however many contracting parties do not appreciate what these terms mean and their significance. This article aims to provide a refresher on the subject.

Traditional Interpretation

At common law, general damages cannot be recovered if the loss suffered is too remote from the corresponding breach of contract.

As such, parties must consider whether the loss falls within the limbs of the "remoteness test" contained in the well-known British case of *Hadley v Baxendale.*[1]

First limb – losses that may fairly and reasonably be considered as arising naturally from the breach of contract; or

Second limb – losses that may reasonably have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach.

Losses which fall within the first limb became known as "**direct or normal losses**". The losses described in the second limb were known as "**indirect or consequential losses**".

Modern Interpretation

In more recent times, the Victorian case of *Peerless*[2] drew a distinction between:

- "normal loss, which is loss that every plaintiff in a like situation will suffer"; and
- "consequential loss, which is everything beyond the normal measure of damage, such as profits lost and expenses incurred through breach".

This had the effect of **broadening** the range of losses recoverable under the second limb of *Hadley v Baxendale* and signified a move away from the traditional formulation.

Since *Peerless*, a number of other courts have considered clauses which purport to exclude consequential loss. In *Alstom Ltd v Yokogawa Australia Pty Ltd and Anor (No 7)* [2012] SASC 49 the South Australian Supreme Court noted that:

"…unless qualified by its context [the word "consequential"]… would normally extend, subject to rules relating to remoteness, to all damages suffered as a consequence of a breach of contract. That is not necessarily the same as loss or damage consequential upon a defect in material where other remedies are also provided."[3]

As *Alstom* ultimately concluded that the term "consequential loss" must be given its ordinary and natural meaning, it is considered by some commentators as reflecting an even broader approach than *Peerless* to consequential loss.

Western Australia

The most recent Western Australian Supreme Court decision regarding the interpretation of exclusion clauses and consequential loss is the single judge decision in *Regional Power Corporation v Pacific Hydro Two Pty Ltd* [2013] WASC 356.

In this case, the Court held that the words "indirect or consequential" do not have a fixed meaning and ought instead to be construed in light of their context according to general principles of construction.[4]

His Honour (Martin J) allowed (as direct damages for a flooding of a gas fired power station) the costs of replacement diesel generators and accommodation and travel costs for the necessary personnel to operate the power station on that basis.

In reaching this decision, Martin J considered both the traditional and modern approaches to interpreting the term "consequential loss" and concluded that both were artificial. He observed that they dealt with the question of construction according to a predisposition, in one case (*Hadley v Baxendale*), based on remoteness and in the other (*Peerless*), a measure of damages, as follows:

"…ordinary businesspersons 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"*[5]

1 *Hadley v Baxendale* (1854) 9 Exch 341

2 *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd* [2008] VSCA 26

3 *Alstom Ltd v Yokogawa Australia Pty Ltd and Anor* (No 7) [2012] SASC 49 at [273] and [281].]

4 *Regional Power Corporation v Pacific Hydro Two Pty Ltd* [2013] WASC 356 at [96] and [97]

5 Emphasis added *Environmental Systems Pty Ltv v Peerless Holdings Ltd [2008] VSCA 26 at [389]*

Consequently, Martin J did not accept that consequential loss meant *loss beyond the normal measure of damages* (as propounded in Peerless).[6] He concluded that the ambit of a clause purporting to limit liability for consequential loss should be *"determined by construing the clause according to its natural and ordinary meaning, read in light of the contract as a whole."*[7]

Drafting Exclusion Clauses

Parties should carefully consider clauses which attempt to exclude or limit indirect and consequential loss.

To avoid any uncertainty, we recommend parties consider the following:

- Who will benefit from the exclusion clause? Will it be mutual?
- What are the types of loss likely to arise and who should bear the risk of each category of loss?

A failure to adequately detail any excluded heads of loss in the drafting could result in the party wishing to rely upon the exclusion having to determine whether losses suffered are "direct" or "indirect" (to establish whether damages are payable). Parties will want to avoid this complex, uncertain and time consuming task.

- Any heads of loss that should not form part of the exclusion clause. For example:
  - Liability which is covered by a policy of insurance.
  - Liability for fraud, wilful misconduct or negligence.
  - Liquidated damages (or any unliquidated damages recoverable due to the liquidated damages provision being unenforceable).

If so, the carving out of the exclusion provisions, in a separate clause, should be considered.

6 *Regional Power Corporation v Pacific Hydro Two Pty Ltd* [2013] WASC 356 at [91] – [96]

7 Ibid [68] – [70], applying *Darlington Futures Ltd v Delco Australia Pty Ltd* [1986] HCA 82: (1986) 161 CLR 500, 510 as applied recently in Electricity Generation Corporation t/as Verve Energy Woodside Energy Ltd [2013] WASCA 36

The Meaning of "Under a Construction Contract" in the Construction Contracts Act

A recent WA Supreme Court case affirms the narrow interpretation of the term "arisen under a construction contract" contained in the *Construction Contract Act 2004* (WA) (**CCA**) to exclude a *quantum meruit* claim based on quasi-contract or restitution. On that basis, an adjudicator will have no jurisdiction to hear the merits of such a purported payment dispute.

Background

Delmere and Alliance Infrastructure Pty Ltd entered into a subcontract on 20 December 2013 under which Alliance agreed to supply, deliver and install pipes at a site in Cape Lambert, Western Australia.

On 9 October 2014, Alliance submitted a variation claim (**VC17**) headed "Re: VARIATION CLAIM No 017". This was rejected by Delmere.

On 7 November 2014, Alliance filed an adjudication application under the CCA using VC17 as the basis of the claim. Alliance did not issue a payment claim to Delmere in respect of VC17 until three days *after* the adjudication application had been filed (**Invoice 024**).

The adjudicator (Mr Barry Green) determined (*inter alia*) that Delmere had been unjustly enriched by changing the subcontract work methodology and ordered Delmere to pay AU$873,011.87 (including GST) to Alliance.

Construction Contracts Act

Under section 25 of the CCA, a party can apply for adjudication if a "payment dispute" has arisen **under a construction contract** (emphasis added).

A "payment dispute" has occurred if sums claimed in a payment claim are due to be paid under the contract and have (a) not been paid full by the time it is due to be paid; or (b) the payment claim has been rejected in full or wholly or partly disputed.[1]

1 Section 3, CCA.

Judicial Review

Delmere sought judicial review of the adjudicator's determination and cited six grounds in its application, including:

- The adjudicator misconstrued the definition of "payment claim" (section 3 of the CCA) and wrongly proceeded on the basis that a "payment claim" includes a claim for unjust enrichment; and
- The adjudicator had failed to consider the terms of the subcontract in determining whether there was a "payment claim" under the subcontract for the purposes of the CCA.

Judicial Review Determination

Justice Martin quashed the adjudicator's decision and held that a relevant "payment claim" had not been issued by Alliance as:

- VC17 did not constitute a payment claim. Despite an attempt by Alliance to re cast VC17 as a payment claim, it was clearly designed by Alliance as a variation claim to which approval was sought; and
- Invoice 024 (which was a payment claim) was issued by Alliance three days after the adjudication application had been filed.

As a payment claim had not been issued to Delmere, it was determined that a "payment dispute"[2] had not occurred therefore Mr Green had no jurisdiction to adjudicate on the merits of Alliance's claim.

In addition, Martin J restated the principle that claims being pursued outside of the underlying contract do not satisfy the requirement that a "payment dispute" has arisen **under a construction contract**.

Instead, Martin J interpreted the words "under a construction contract" narrowly to exclude payment disputes which are "**in relation to**" the construction contract, such as a claim for unjust enrichment.

In another recent case, Kellogg Brown & Root Pty Ltd (**KBR**) applied for judicial review to determine (*inter alia*) that claims made by Doric Contractors Pty Ltd were not made "under a construction contract" as they were made after the contract was terminated; therefore a "payment dispute" under the CCA had not occurred.[3]

The substantive hearing for KBR's judicial review application is pending.

2 Section 6, CCA.

3 *Kellogg Brown & Root Pty Ltd v Doric Contractors Pty Ltd* [2014] WASC 206

Contacts

Greg Steinepreis
Partner
T +61 8 9429 7505
E greg.steinepreis@squirepb.com

Brendan Reilly
Partner
T +61 8 9429 761
E brendan.reilly@squirepb.com

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