Investing in Infrastructure | International Best Legal Practice in Project and Construction Agreements | January 2016

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Position paper on liability

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Introduction

This paper sets out the legal principles that apply to key provisions in construction contracts and focuses on those issues that contractors raise in an attempt to limit their liability.

It focuses on international market practice and the position under English law, which most participants in the projects and construction industry in this region are familiar with.

Summary

Contractors often raise various arguments concerning provisions relating to time and performance which, if accepted, can have serious consequences for an Employer's ability to recover.

Contractors often argue for:

- the insertion of an exclusive remedies clause for delay and performance liquidated damages and the removal of any failsafe provisions
- the insertion of a general exclusive remedies clause
- the deletion of provisions that attempt to obviate the effects of the Prevention Principle
- no liability for consequential loss
- the exclusion of all implied warranties.

This position paper sets out the legal issues that Employers need to be aware of in dealing with these issues.

Specifically, we explore:

- the operation of liquidated damages clauses and how they can be invalidated
- the impact of exclusive remedies clauses on liquidated damages regimes
- the rationale for, and meaning of, exclusive remedies clauses under construction contracts
- the operation of the Prevention Principle
- the operation of consequential loss provisions
- the application of implied warranties.

It should be emphasised that this paper focuses on the legal risks to Employers; it does not focus on commercial imperatives or technical issues.

How liquidated damages regimes can be invalidated

If an exclusive remedies clause is inserted into a contract, the explicit remedies contained in the contract will take on great significance. Under English law, from a construction law perspective, the presence of liquidated damages will be crucial in providing remedies for delay and underperformance.

However, if a general exclusive remedies provision is inserted, the Employer may have no recourse to common law damages if the liquidated damages regime is invalidated. Contractors attempt to invalidate liquidated damages clauses in a number of ways. The most common methods of circumventing these clauses are by arguing that:

- the liquidated damages clause is a penalty or void for uncertainty
- the Employer has caused delay through an act of prevention.

Liquidated damages not a genuine pre-estimate of loss, but a penalty

If the sum agreed to be imposed by the parties as liquidated damages is, in law (or equity), a penalty, then it will not be enforceable by an Employer (at least to the extent that it is penal in nature). The sum agreed to be imposed as liquidated damages will be regarded as a penalty if it does not represent a genuine pre-estimate of the loss likely to be sustained by the Employer as a result of a delay to completion. As stated by the Privy Council:

"...so long as the sum payable in the event of non-compliance with the contract is not extravagant, having regard to the range of losses that it could reasonably be anticipated it would have to cover at the time the contract was made, it can still be a genuine pre-estimate of the loss that would be suffered and so a perfectly valid liquidated damage provision."[1]

The question of whether a clause is a penalty is one of construction to be decided upon the terms and circumstances of each particular contract at the time of formation. If it can be established that the sum is not a genuine pre-estimate of loss because it is too great a figure, the provision will be unenforceable at common law and in equity it will be read down the clause and enforce it to the extent that it reflects the damage suffered.[2] It makes no difference that the contract specifically states that the clause is not a penalty[3] or in fact the contract uses the word "penalty" (as some still do) provided the sum is in reality a genuine estimate of damage (and so follows general common law damages principles) or is intended as a limitation of damage and not *in terrorem*.[4] However, in all cases where the act in question is a breach of contract, the law will inquire whether the payment provided for in the contract is a "penalty", in a modern sense of the word, meaning that it is not in reality a genuine pre-estimate of damage and is excessive or "out of all proportion" with the likely loss flowing from the breach.[5]

In practice, liquidated damages clauses in major infrastructure projects that are financed on a non – or limited recourse basis are not likely to be considered excessive or out of proportion, as they are estimated below the likely loss that an Owner would suffer. Therefore, the more relevant risk is if they are drafted in a way that is too uncertain to be enforced.

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1 Xxx

2 Xxx

3 *Philips Hong Kong Ltd v The Attorney General of Hong Kong* [1993] 61 BLR 49, 59 (Lord Woolf).

4 *Jobson v Johnson* [1989] 1 WLR 1026; *Andrews v Australia and New Zealand Banking Group Ltd* (2012) 247 CLR 205.

5 *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79, 86.

Time at large

If an Employer prevents the completion of the works in a way not covered by an extension of time clause, then it loses the right to claim liquidated damages. If this occurs, the Contractor cannot complete by the set completion date and it is said that time under the contract has been set "at large". This means that the Contractor's obligation is to complete the works within a reasonable time. Time is said to be set at large due to the operation of the Prevention Principle. What is a reasonable time to complete once time has been set at large is a matter of fact dependent on the circumstances as to how time has become at large, the date on which it was set at large and the materials to be able to make a calculation.[6]

The potential for a liquidated damages clause to be declared a penalty and be read down or invalidated increases the importance of failsafe clauses and other provisions that preserve an Employer's rights to claim damages at law.

Removal of failsafe clauses for delay and underperformance

Failsafe provisions in construction contracts attempt to preserve the Employer's rights to obtain damages at law if for some reason the liquidated damages clauses are deemed unenforceable. A typical failsafe provision for delay provides as follows:

If this provision (or any part thereof) is found for any reason to be void, invalid or otherwise inoperative so as to disentitle the Employer from claiming delay liquidated damages, the Employer is entitled to claim against the Contractor damages at law as set out in the damages at law schedule for the Contractor's failure to attain commercial operation by the date for commercial operation up to the aggregate liability for delay liquidated damages.

Contractors often argue against such clauses and suggest they should be deleted. They often argue for the inclusion of an exclusive remedies provision and the deletion of any failsafe clause, suggesting that liquidated damages should be an Employer's sole entitlement for the Contractor's delay or underperformance. As explained below, exclusive remedies clauses may prevent an Employer from claiming damages at common law in the event that the liquidated damages regimes are for some reason found to be unenforceable.

If there is no exclusive remedies clause, then there is no essential need for the inclusion of failsafe clauses. However, if an exclusive remedies clause is inserted – which we advise against below – failsafe clauses must be included to protect the Employer's ability to recover. If an exclusive remedies clause is present, failsafe clauses provide essential protection if the liquidated damages regimes are for any reason invalidated. While the High Court in *Andrews v Australia and New Zealand Banking Group Ltd*[7] indicated that in equity a penalty can be enforced to the extent it reflects appropriate compensation, that principle will not have application where a liquidated damages clause is considered void for uncertainty, rather than being a penalty because it is excessive in amount.

6 This point was strongly suggested by the Court of Appeal judgments in *Widnes Foundry v Cellulose Acetate* [1931] 2 KB 393 and finally and satisfactorily concluded by the Supreme Court of Canada in *Elsley v J.G. Collins Insurance Agencies Ltd* [1978] 2 SCR 916.

7 Ian D Wallace (ed), *Hudson's Building and Engineering Contracts* (Sweet & Maxwell, 11th ed, 1994) vol 2, [10.002].

Exclusive remedies generally

Contractors typically attempt to insert a provision stating that the remedies expressly provided for under the construction contract are to the exclusion of any remedies at common law. Contractors also typically attempt to delete any reference to recourse to damages at law.

The insertion of an exclusive remedies clause may have far-reaching consequences as it may limit an Employer's rights to those explicitly articulated in the construction contract. This potentially leaves the Employer without remedies for the Contractor's breaches of the construction contract, as we explain below.

A typical comprehensive exclusive remedies clause is as follows:

The Employer and the Contractor agree that their respective rights, obligations and liabilities as provided for in the contract shall be exhaustive of the rights, obligations and liabilities of each of them to the other arising out of, under or in connection with the contract or the works, whether such rights, obligations and liabilities arise in respect or in consequence of a breach of contract or of statutory duty or a tortious or negligent act or omission which gives rise to a remedy at common law. Accordingly, except as expressly provided for in the contract, neither party shall be obligated or liable to the other in respect of any damages or losses suffered by the other which arise out of, under or in connection with the contract or the works, whether by reason or in consequence of any breach of contract or of statutory duty or tortious or negligent act or omission.

The effect of this clause would considerably affect the Employer's ability to recover. The final sentence is particularly comprehensive, as it provides that, other than those clauses in the contract for which a remedy is specifically provided, the Employer would not be able to recover damages from the Contractor for breaches of the engineering, procurement and construction (**EPC**) Contract or for negligence. It follows that, if there has been a failure by the Contractor to satisfy a contractual obligation, or if the Contractor has been negligent under the contract, then unless the Employer can point to a specific and express remedy under the contract for such breach or negligence, it would be left without a remedy.

An EPC Contract will typically provide specific remedies in the form of liquidated damages for delay and underperformance of the project. Delay and underperformance are only two issues, however, for which an Employer will require contractual compliance. There will be numerous other Contractor obligations under the EPC Contract with which the Employer will require compliance and for which a remedy should be available in the event of non-compliance or breach. If a comprehensive exclusive remedies clause is inserted, the Contractor may be able to breach numerous provisions of the EPC Contract, or behave negligently in respect of certain conduct, without consequence.

For example, consider the scenario under an EPC Contract in which the Contractor has brought the project to practical completion/commercial operation and the liquidated damages regime is no longer required. After commercial operation, there remain various opportunities and possibilities for breach. One example is the Contractor's failure to provide spare parts in accordance with the terms of the EPC Contract. The exclusive remedies clause may have the effect of preventing the Employer from claiming common law remedies for breaches of other provisions of the contract in such a situation. Another example is a breach of the Contractor's warranty that the works will be fit for the purpose reasonably inferable from the contract.

Exclusion of common law damages

Commonly, if a liquidated damages clause is found to be unenforceable (because it is a penalty, void or otherwise unenforceable), the Employer, while prevented from claiming liquidated damages, still has the right to claim damages at common law (or in equity may be entitled to enforce an excessive penalty clause to the extent that it would amount to appropriate compensation).

Exclusive remedies provisions exclude the ability of an Employer to claim common law damages in the event the liquidated damages regime is declared unenforceable, thereby restricting the Employer's remedies for delay or underperformance to liquidated damages. If an exclusive remedies clause is inserted, a further question to be determined is to what extent common law damages are unavailable, that is, whether the clause excludes all common law remedies or only those provisions for which liquidated damages are available.

It is clear that whether the terms of a contract constitute a codification of the rights and liabilities of the parties to it (including a complete statement of those rights and liabilities where one party defaults in a contractual obligation so as to exclude common law rights to damages) depends on the construction of each individual contract.[8] It is well established that if a party's common law right to sue for damages for breach of contract is to be removed contractually, it must be done by clear words.[9]

Courts have held that clear wording may remove the common law right to damages. This view has been followed in a number of cases, including *Hancock v BW Brazier (Anerley) Ltd* [1966] 1 WLR 1317 (CA); *Billyack v Leyland Construction Co Ltd* [1968] 1 WLR 471; *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827 and *HW Nevill (Sunblest) Ltd v William Press & Son Ltd* [1981] 20 BLR 78. The High Court in *Concut Pty Ltd v Worrell*[10] *has said that "clear words are needed to rebut the presumption that a contracting party does not intend to abandon any remedies for breach of the contract arising by operation of the law".*[11]

It was held in *Peak Construction (Liverpool) Ltd v McKinney Foundations Ltd*[12] that a proprietor may lose his right to rely upon a liquidated damages clause providing for liquidated damages in the event of delay in completion if the proprietor caused or contributed to the delay.[13] However, in *Billyack v Leyland Construction Co Ltd*[14] Davies LJ stated:

"It requires very clear words to debar a building Employer from exercising his ordinary rights of suing if the work done is not in accordance with the contract."

The possibility of broadening this position was considered by Lord Diplock in *Photo Production Ltd v Securicor Transport Ltd*.[15]

Since the obligations implied by law in a commercial contract are those which, by judicial consensus over the years or by Parliament in passing a statute, have been regarded as obligations that a reasonable businessman would realise that he was accepting when he entered into a contract of a particular kind, the court's view of the reasonableness of any departure from the implied obligations that would be involved in construing the express words of an exclusion clause in one sense that they are capable of bearing rather than another is a relevant consideration in deciding what meaning the words were intended by the parties to bear. But this does not entitle the court to reject the exclusion clause, however unreasonable the court itself may think it is, if the words are clear and fairly susceptible of one meaning only.

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8 Keith Pickervance, 'Calculation of a Reasonable Time to Complete when Time is at Large', [2006] *International Construction Law Review* 167, 168.

9 (2012) 247 CLR 205.

10 Stephen Furst and Sir Vivian Ramsey (eds), *Keating on Construction Contracts*, (Sweet & Maxell, 8th ed, 2006), [10.023].

11 *Hancock v BW Brazier (Anerley) Ltd* [1966] 1 WLR 1317,1334 (Denning MR); *Billyack v Leyland Construction Co Ltd* [1968] 1 WLR 471, 475 (Edmund Davies LJ); *H W Nevill (Sunblest) Ltd v William Press & Son Ltd* (1981) 20 BLR 78, 88 (Judge Newey).

12 (2000) 176 ALR 693.

13 Ibid, 699-70; see also *Stocznia Gdanska SA v Latvian Shipping Co* [1998] 1 WLR 574.

14 [1970] 1 BLR 111.

15 See also *Spiers Earthworks Pty Ltd v Landtec Projects Corporation Pty Ltd [No 2]* [2012] WASCA 53, [49].

On a broad interpretation, this suggests that if, on the structure of the contract as a whole, it appears that a party has surrendered its rights to common law damages by the insertion of a particularly comprehensive exclusive remedies clause, that party may not have any remedies other than those specifically and particularly stated in the contract.

This argument becomes increasingly persuasive when considered in light of the decision in *Temloc Limited v Erril*[16] in which it was held that the word "nil" in a damages annexure was evidence that the parties intended no liability for either liquidated or unliquidated damages. Nourse LJ noted:

"I think it clear, both as a matter of construction and as one of common sense, that if…the parties complete the relevant part of the Appendix,…then that constitutes an exhaustive agreement as to the damages which are or are not to be payable by the Contractor in the event of his failure to complete the works on time."[17]

These cases suggest that the inclusion of an exclusive remedies clause, then, is a step that can have extremely significant consequences.

The effect of an exclusion of common law damages

Therefore, while the insertion of an effectively drafted exclusive remedies clause will prevent the Employer from claiming common law damages for delay or underperformance in the event that the liquidated damages clause is declared invalid, it may have far-reaching effects on other clauses of the contract.

Rule at law against double recovery

It is a well-established principle that the law (which now embraces equity) will not permit a plaintiff, whatever procedural device is used, to recover more than the damages which have been suffered, no matter what the cause of action: *Baxter v Obacelo Pty Ltd* (2001) 205 CLR 635 as most recently applied in *Ewin v Vergara (No 3)* [2013] FCA 1311. Given the possible severe and wide ranging consequences for both parties if an exclusive remedies clause is inserted, and in light of the well-established (in English and Australian law) principle of double recovery which will operate to have the same effect as an exclusive remedies clause (that is, prohibit an Owner from recovering, for example, liquidated damages under contract for delay and damages at law for the same delay), it is prudent that an exclusive remedies clause be excluded from a contract.

Proposed solutions

One option is for an Employer to accept the Contractor's exclusive remedies clause, but carefully to elaborate those clauses of the contract for which a remedy is required in the event of breach. These express remedies could then be specifically included in the contract and could operate alongside the exclusive remedies clause. However, in our view, such a strategy is risky, because the Employer would be required to identify all potential breaches of the EPC Contract, and also to consider which remedies should be expressly identified to deal with such breaches. In our view, it is not possible to envisage the different ways in which a Contractor may breach its contractual obligations, and the consequences the Employer may suffer as a result of the breach.

The preferable solution is to resist the inclusion of an exclusive remedies clause, thereby ensuring maximum latitude to claim for damages at law if the liquidated damages regime is for some reason declared unenforceable.

Failing this approach, the other option is to include a "code of rights" provision in the EPC Contract, providing that, except where express remedies are specifically provided under the contract (for example, provisions providing for liquidated damages), each party will be able to claim common law damages for breaches of the contract.

16 [1968] 1 WLR 471.

17 [1980] AC 827.

The operation of the Prevention Principle

Rationale

There are various rationales for the existence of the Prevention Principle under English law. These have been variously suggested as:

- the principle that a party should not be able to recover from damages for what that same party has caused[18]
- an implied term or implied supplemental contract[19]
- waiver or estoppels[20]
- unjust enrichment.

Others have suggested that there is in fact no coherent overarching rationale for the Prevention Principle or that it may be regarded as a particular manifestation of the obligation to cooperate implied as a matter of law in all contracts.[21] In any case, the fundamental considerations are of fairness and reasonableness.[22]

Operation

The operation of the Prevention Principle will ensure that an Employer will lose its right to claim liquidated damages for delay if that delay was due to its own, employee's or agent's defaults, where there is no extension of time clause that specifically provides for extensions due to acts or defaults of the Owner and an extension has been validly granted thereunder.[23] A claim that the Prevention Principle operates to set time at large usually arises in the following circumstances:

- where a Contractor alleges that the power to extend time has not been exercised, or has been exercised improperly
- where there is no clause under the contract to extend time for the Employer's act of delay, or where that power cannot be exercised in the circumstances.

What acts or omissions of the Employer bring the Prevention Principle into operation? Courts generally have regarded any wrongful act or fault as sufficient to enliven the principle. It is not necessary that the act constitutes a breach of contract.[24] The broadest view is that any act of the Employer, regardless of its fault element, is sufficient to engage it. Variations, whether authorised under the original contract or subsequently agreed, are regarded as acts of prevention for the purposes of the doctrine.[25]

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18 [1987] 39 BLR 30.

19 Ibid 39.

20 *Peak Construction (Liverpool) Ltd v McKinney Foundations Ltd* [1970] 1 BLR 111.

21 *SBS International Pty Ltd v Venuti Nominees Pty Ltd* [2004] SASC 151, [11] (Besanko J).

22 Ibid.

23 *SMK Cabinets v Hili Modern Electrics* [1984] VR 391, 397 (Brooking J).

24 *Secured Income Real Estate (Australia) Ltd v St Martins Investments Pty Ltd* (1979) 144 CLR 596, 607 (Mason J); *Spiers Earthworks Pty Ltd v Landtec Projects Corporation Pty Ltd* (No 2) [2012] WASCA 53, [46].

25 Wallace, above n 5.

In considering whether an extension of time clause provides for the granting of extensions of time for Employer-caused delay, the extension of time clause will be construed *contra proferentem* against the Employer. It is established that general or ambiguous words in an extension of time clause, referring to such matters as "events beyond the control of the Employer", will not entitle the Employer to the benefit of the liquidated damages regime.[26] Where the extension of time clause provides specifically for the Employer's breach, waiver or prevention, the liquidated damages regime will be preserved. As stated by Salmon LJ in *Peak Construction (Liverpool) Ltd v McKinney Foundations Ltd* (**Peak**):[27]

"The liquidated damages and extension of time clauses in printed forms of contract must be construed strictly contra proferentem. *If the Employer wishes to recover liquidated damages for failure by the Contractors to complete on time in spite of the fact that some of the delay is due to the Employers' own fault or breach of contract, then the extension of time clause should provide, expressly or by necessary inference, for an extension on account of such a fault or breach on the part of the Employer."*[28]

One of the more contentious aspects of this area of law concerns the interaction of conditions precedent to the granting of an extension of time with the operation of the Prevention Principle. The issue is whether the Prevention Principle is subject to an administrative act (such as the provision of notice by the Contractor) or whether it can operate independently of such procedural requirements of particular contracts.

Case law on this point is divided. In *Gaymark v Walter Construction* (**Gaymark**),[29] the contract under dispute provided that a notice of delay was to be given within 14 days of the cause of delay arising. The Supreme Court of the Northern Territory reaffirmed an arbitral award that found that, even though the notice requirements were not complied with by the Contractor, because at least some of the delay was caused by the Employer, the right to claim liquidated damages was lost and time was set at large. Gaymark suggests that the Prevention Principle overrides conditions precedent. This view has been subjected to strong academic criticism.[30]
Later cases have suggested that conditions precedent must be satisfied before the Prevention Principle can have application. Indeed, in *Turner Corporation Limited (Receiver and Manager Appointed) v Austotel Pty Ltd*[31] Cole J stated that the builder could not:

"… claim that the act of prevention which would have entitled it to an extension of the time for practical completion resulted in its inability to complete by that time. A party to a contract cannot rely upon preventing conduct of the other party where it failed to exercise a contractual right which would have negated the affect [sic] of the preventing conduct."[32]

A further question regarding the scope of the Prevention Principle concerns what is actually invalidated by the Employer's act of prevention. If the Employer causes four days of delay to a programme, and the Contractor is 100 days late in delivery of the project, can the Employer recover 96 days of liquidated damages, or is the entire liquidated damages regime invalidated? In such a scenario, what is considered to be a reasonable time to complete?

Early authority on this point favoured the view that any act of prevention by the Employer invalidated the entire liquidated damages regime. In *Holme v Guppy*[33] the delay in completion was five weeks; the Employer was responsible for four weeks of delay and the Contractor for one week of delay. The court found that the Employer was not entitled to any liquidated damages due to its act of prevention. In *Hudson's Building and Engineering Contracts*, Wallace notes that:

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26 Doug Jones, "Can prevention be cured by time bars?" (2009) (Paper 158) *Society of Construction Law*.

27 *Multiplex Constructions (UK) Ltd v Honeywell Control Systems Ltd* [2007] BLR 195.

28 Wallace, above n 5.

29 [1970] 1 BLR 111.

30 Ibid, 121; see also *D & M (Australia) Pty Ltd v Crouch Developments Pty Ltd* [2011] WASCA 109, accepting Peak.

31 [1999] 16 BCL 449.

32 Ian D Wallace, "Prevention and Liquidated Damages: A Theory Too Far?" (2002) 18 *Building and Construction Law* 82.

33 *Turner Corporation Ltd (Receiver and Manager Appointed) v Austotel Pty Ltd* (1994) 13 BCL 378.

"... (unless) there is a sufficiently specific clause, it is not open to the Employer or his A/E (independent engineer) where the contract date has ceased to be applicable, to make out a kind of debtor and creditor account allowing so many days or weeks for delay caused by the Employer and, after crediting that period to the builder, to seek to charge him with damages at the liquidated rate for the remainder."[34]

This view appears to be based on the needs of certainty and predictability and finds its foundation in the classic case of *Peak*. More recent authority suggests that the Employer's delay and the Contractor's delay could be in some circumstances divisible for the purposes of determining and enforcing liquidated damages, but remains circumspect in light of Peak's authority. In *Rapid Building Group Ltd v Ealing Family Housing Association Ltd*[35] Lloyd LJ remarked that:

"... I was somewhat startled to be told in the course of the argument that if any part of the delay was caused by the Employer, no matter how slight, then the liquidated damages clause in the contract... becomes inoperative.

"I can well understand how that must necessarily be so in a case in which the delay is indivisible and there is a dispute as to the extent of the Employer's responsibility for that delay. But where there are, as it were, two separate and distinct periods of delay with two separate causes, and where the dispute relates only to one of those two causes, then it would seem to me just and convenient that the Employer should be able to claim liquidated damages in relation to the other period."[36]

Nevertheless, Lloyd LJ went on to note that "*it was common ground before us that is not a possible view...in the light of the decision of the Court of Appeal in Peak's case, and therefore I say no more about it*."[37]

Accordingly, the classic case of Peak remains dominant, with the subsequent line of authority suggesting that where an act of prevention goes to part of the delay but not the whole, the entire liquidated damages clause will be invalidated.[38] This traditional view has recently been reinforced in Australia in *SBS International Pty Ltd v Venuti Nominees Pty Ltd*,[39] where Besanko J held that, in a situation where delay to the completion date is caused by the Contractor as well as the Principal, it is not open to a court to apply the liquidated damages clause to the delay specifically caused by the Contractor:

"In those cases where both Principal and Contractor are responsible for delay, the liquidated damages clause will be held inapplicable unless there is a contractual provision by way of an appropriate extension of time clause which accommodates or deals with the delay caused by the contract of the Principal".[40]

To summarise, an Employer will not lose its rights to claim liquidated damages if:

- the delay is due wholly or in part to an act of prevention
- there is a provision in the contract providing for extensions of time due to acts of prevention
- an extension of time has been certified pursuant to the contract.

34 Ibid. *Turner* has been accepted as correct in *Peninsula Balmain Pty Ltd v Abigroup Contractors Pty Ltd* (2002) 18 BCL 322; *620 Collins Street Pty Ltd v Abigroup Contractors Pty Ltd (No 2)* [2006] VSC 491. McLure P indicated that all Australian courts were bound to follow that approach in *Spiers Earthworks Pty Ltd v Landtec Projects Corporation Pty Ltd (No 2)* [2012] WASCA 53, [53]-[56].

35 (1838) 3 M&W 387.

36 Wallace, above n 5, [10.025].

37 (1984) 29 BLR 5.

38 [2007] BLR 195; Pickervance, above n 6, 177.

39 (1984) 29 BLR 5, 19.

40 Wallace, above n 5, [10.040].

It is prudent to include a provision permitting the Employer to make an extension of time at its discretion, even where the Contractor has not requested one. Such a provision makes it possible to avoid the situation where a Contractor is entitled to an extension of time due to any act of prevention, but has not applied for one on the basis that it can rely on the Prevention Principle. We suggest that the contract should provide that a cause of delay entitling the Contractor to an extension of time includes:

- any act, omission or default by the Employer, the Employer's representative and their agents, employees and contracting counterparties

- a variation, except where that variation is caused by an act, omission or default of the Contractor or its sub contractors, agents or employees.

The contract should also include a condition precedent provision with which the Contractor must comply before an extension of time can be granted.

Can the Prevention Principle be contracted out of?

The question arises whether the Prevention Principle can be explicitly contracted out of, so that a liquidated damages regime can remain on foot despite the Contractor being prevented due to the Employer delaying the works.

As well as providing for extensions of time for acts or omissions of the Employer, our standard EPC Contract attempts to contract out of the Prevention Principle as follows:

- *Any principle of law or equity (including the Prevention Principle and those which might otherwise entitle the Contractor to relief), which might otherwise cause the date for commercial operation to be set at large and liquidated damages unenforceable, will not apply*

- *For the avoidance of doubt, a delay caused by any act or omission of the Employer or any failure by the Employer or the Employer's representative to comply with this clause will not cause the date for commercial operation to be set at large*

- *Nothing clauses 1 or 2 will prejudice any right of the Contractor to claim an extension of time or delay costs in accordance with this contract for that delay.*

While we believe that this clause is valid, and that the Prevention Principle can be contracted out of, we must emphasise that this view has not yet received judicial confirmation. There do not appear to be any cases directly in point. However, general principles of law in related areas may provide guidance in this area.

The doctrine of freedom of contract suggests that parties are given considerable latitude in determining the terms of their commercial bargain. In 1993, the Privy Council of the United Kingdom quoted approvingly the view that:

"...the power to strike down a penalty clause is a blatant interference with freedom of contract and is designed for the sole purpose of providing relief against oppression for the party having to pay the stipulated sum. It has no place where there is no oppression."[41]

Generally speaking, "although the principle of freedom of contract rests on the premise that individuals are free to make agreements as they wish, the public interest in freedom of contract can be outweighed by other public policy considerations."[42] Providing an agreement does not offend public policy, then it will be enforced in its terms. However, equity may prevent the reliance on contractual provisions where there is demonstrated unconscionable conduct. As yet, there is no judicial consideration of such an approach in relation to reliance upon a clause excluding the Prevention Principle.

41 [2004] SASC 151.

42 Ibid, [12] (Besanko J).

Indirect and consequential loss

Introduction

Contractors often attempt to limit their liability by attempting to exclude all "consequential loss" from liability, or by explicitly excluding certain heads of loss under the construction contract.

It is common practice in standard form EPC Contracts to refer to both "indirect" and "consequential" loss or damage in exclusion of liability clauses.

Under Australian law, the view had been that there was no legal difference between the words "indirect" and "consequential" in exclusion of liability clauses, until relatively recently. However, case law from Victoria that is likely to be applied in other Australian jurisdictions has now held that consequential loss has a broader meaning than previously assumed. The following explains this change and how parties should interpret these words in commercial negotiations.

Under English law, the distinction between indirect and consequential loss, and direct loss, is less certain.

The scope of indirect or consequential loss or damage

Position under English law

The well-known English case of *Hadley v Baxendale*[43] provides that where a party to a contract is in breach, the damages to which the other party is entitled falls under two limbs, namely, damages such as may fairly and reasonably be considered:

- to arise naturally, ie according to the usual course of things, from such a breach of contract (often referred to as direct loss or damage) (first limb)
- to be in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of contract (often referred to as indirect loss or damage) (second limb).

Under English law, the term "consequential" is confined to the second limb of the rule in *Hadley v Baxendale*. On this view, the term "indirect or consequential loss or damage" would not include any loss that arises naturally upon the breach, but would include loss or damage that was in the contemplation of both parties, at the time the contract was made, as the probable result of its breach.

Under English law, in determining whether a loss is direct or indirect, it has been held that the enquiry is whether the losses arise naturally and in the ordinary course of things.[44]

English case law has considered which types of loss are typically seen as direct and which are considered indirect or consequential. It is important to emphasise that the classification of loss is often dependent on the specific factual scenarios and contractual provisions at issue, and in practice it is often difficult to determine whether a loss falls within the first or second limb of *Hadley v Baxendale*. However, the following types of losses have frequently been considered direct loss by courts:

- loss of profits
- loss of revenue
- loss of opportunity

43 *Philips Hong Kong Ltd v The Attorney General of Hong Kong* [1993] 61 BLR 49, 58. See also *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 190 (Mason and Wilson JJ).

44 *Australian Securities and Investments Commission v Fortescue Metals Group Ltd* (2011) 190 FCR 364, [222].

- increased expenses or wasted expenditure.

Position under Australian law

The Australian courts have previously supported the above English view of indirect or consequential loss or damage as loss or damage that was in the contemplation of both parties at the time the contract was made, as the probable result of the breach.

However, in the case of *Environmental Systems Pty Ltd v Peerless Holdings Pty Ltd*[45] (*Peerless*), the Victorian Court of Appeal moved away from the "second limb test" and decided that the term "consequential loss" should be given its ordinary and natural meaning as would be conceded by ordinary reasonable business persons. In applying this principle, the court drew a distinction between:

- loss that every plaintiff in a like situation will suffer (normal loss)
- anything beyond the normal measure, such as profits lost or expenses incurred through breach (consequential loss).

Peerless was highly influential in the recent decision of *Alstom Ltd v Yokogawa Australia Pty Ltd (No 7)* [46] (**Alstom**), where the Supreme Court of South Australia considered a clause excluding Yokogawa's liability as sub contractor for "*any indirect, economic or consequential loss whatsoever*".

The terms of the contract required the sub contractor to pay damages if it did not complete the works on time or if the works did not meet the performance tests. Alstom made claims against the sub contractor and sought compensation in relation to breaches of these obligations, asserting that the breaches had resulted in losses that flowed naturally from each breach, and therefore were within the first limb of *Hadley v Baxendale*. The sub contractor rejected this assertion and relied upon the exclusion clause, submitting that it should be read more generally to include losses that occurred as a consequence of breach of contract.

The Court considered these claims, and held that the losses claimed by Alstom fell within the first limb, but the breadth of the exclusion clause meant that the sub contractorwas not liable for damages occurring as a consequence of any breaches of contract:

"The expression "indirect … or consequential loss" appears, in this case, as part of a freestanding and powerfully expressed exclusion clause. It is not affected by the immediate presence of any concession as to liability which it might qualify, although it must be read against the background of the qualified exposure of [the sub contractor] to the exclusive remedies of Liquidated Damages and reimbursement of Performance Guarantee Payments. The Article in question was intended to operate in respect of potential liability for loss incurred by Alstom, which was caused by a breach of contract by [the sub contractor] in circumstances other than those giving rise to the payment of Liquidated Damages and reimbursement of Performance Guarantee Payments. The words must be given their ordinary and natural meaning. In those circumstances any loss consequential or following, immediate or eventual, flowing from a breach of contract by [the sub contractor] is excluded from recovery by Alstom."[47]

In so doing, the Court noted Peerless was the preferred precedent over the English cases.

In 2013, the West Australian Supreme Court decision of *Regional Power Corporation v Pacific Hydro Group Two Pty Ltd (No 2)*[48] (**Regional Power**) rejected both the English approach to the construction of the term "consequential loss" as falling under the second limb of *Hadley v Baxendale*, and the view adopted by *Peerless*. *Regional Power* concerned a PPA entered into between Regional Power Corporation (**SECWA**) and Pacific Hydro Pty Ltd for the supply of electricity. The power station suffered an outage resulting in flooding which led

45 [1854] 9 Exch 341.

46 *FG Minter Ltd v Welsh Health Technical Services Organisation* [1980] 13 BLR 1.

47 (2008) 19 VR 358.

48 [2012] SASC 49.

to the power station being inoperative for two months. Resultantly, SECWA claimed damages for breach of the PPA consisting of costs relating to the hiring of replacement diesel generators, cranes and fuel required to run the extra generators; and wages, travel, accommodation and meal expenses of the additional Operators required during that period.

Pacific Hydro argued that the damages claimed by SECWA were indirect or consequential losses and accordingly were excluded from recovery by the following clause 26.1:

Neither the Project Entity nor SECWA shall be liable to the other party in contract, tort, warranty, strict liability, or any other legal theory for any indirect, consequential, incidental, punitive or exemplary damages or loss of profits.

The Court rejected both the *Hadley v Baxendale* and *Peerless* positions in favour of the well settled construction approach by the High Court in *Darlington Futures*, stating:

"*To reject the rigid construction approach towards the term "consequential loss" predicated upon a conceptual inappropriateness of invoking the* Hadley v Baxendale *dichotomy as to remoteness of loss, only then to replace that approach by a rigid touchstone of the 'normal measure of damages' and which always automatically eliminates profits lost and expenses incurred, would pose equivalent conceptual difficulties. Accordingly, I doubt whether the [93] observations in* Environmental Systems *were intended to carry any general applicability towards establishing a rigid new construction principle for limitation clauses going much beyond the presenting circumstances of that case.*

The natural and ordinary meaning of the words of cl 26.1, begins with these words themselves, assessed in their place within the context of the PPA as a whole. That, on my assessment, is the correct approach to a limitation or exclusion clause required by Darlington Futures Ltd v Delco Australia Pty Ltd, *as recently applied by the Western Australia Court of Appeal in* Electricity Generation Corporation t/as Verve Energy v Woodside Energy Ltd *[38], [42] (McLure P), [138], [140] (Murphy JA)…*

Construing 26.1 within the PPA as a whole, the court should not be artificially fettered towards assessing the character of an economic loss by rather vague criteria of whether or not the loss arose 'in the ordinary course of things'. Nor should the court be oriented from the start towards trying to determine if a claimed loss falls under the equally porous concept of a 'normal measure of damage."[50]

Effect on drafting

In summary, there are now three different approaches to the meaning of the words "indirect or consequential" when used in an exclusion clause (or limitation clause, in the instance of Regional Power):

- the English approach, where the words are construed as a reference to damages resulting from special circumstances under which the contract was made communicated by one party to the other
- the *Peerless/Alstom* approach, where the word "consequential" was said to refer to everything beyond the normal measure of damages, such as profits lost or expenses incurred through breach
- the *Regional Power* approach, where the words are said to exclude losses that are in some way less direct and more removed when considered in the context of the transaction at hand.

Contracts governed by Australian law

Darlington Futures holds that limitation (or exclusion) clauses excluding certain categories of loss and damage must be interpreted according to their natural and ordinary meaning, read in the light of the contract as a

49 Ibid, 82.

50 [2013] WASC 356.

51 (1986) 161 CLR 500.

whole, thereby giving due weight to the context in which the clause appears including the nature and object of the contract. This principle of interpretation must be applied by courts in Australia.

The problem however is whilst the *Darlington Futures* decision confirms the contextual, commercial approach to the interpretation of commercial contracts in Australia, there is potential for significant differences in what would, in a given situation, constitute the ordinary and natural meaning of "consequential loss", given the clear requirement that losses claimed be interpreted in context of the contract in question. This is highlighted by the recent conflicting principles as to the scope of "consequential loss" taken by the states below (noting the question is yet to be considered in Queensland, Tasmania, the Australian Capital Territory or Northern Territory):

- ***Victoria, New South Wales and South Australia***: "consequential loss" is what an ordinary reasonable business person would consider consequential loss ie everything beyond the normal measure of loss (loss that every plaintiff in a like situation will suffer). Lost profits and expenses incurred as a result of breach were given as two examples of consequential losses: *Peerless*; *Alstom*

- ***Western Australia***: "consequential loss" is given its natural and ordinary meaning, read in light of the contract as a whole (ie rejecting the above position and reinforcing the High Court position): Regional Power.

As a result of these decisions, the term "indirect or consequential" should no longer be interpreted as confined to the second limb of the rule in *Hadley v Baxendale*. Instead, any exclusion of indirect or consequential loss should be understood as also excluding some categories of loss that would otherwise be considered to fall under the first limb of *Hadley v Baxendale*; to be determined by construing the clause according to its natural and ordinary meaning, read in the light of the contract as a whole.

Contracts governed by English law

In contracts governed by English law, the following consequential loss clause should be included:

"Without prejudice to the Employer's right to recover liquidated damages or damages at law for delay or underperformance under clauses 24 and 25 or where otherwise stated in the contract, neither party is liable to the other under the contract, law of tort, including negligence, statute, inequity or otherwise for any kind of indirect or consequential loss or damage including, loss of use, loss of profit, loss of production or business interruption which is connected with any claim arising under the contract or the subject matter of the contract."

The wording of this clause permits the Employer a certain degree of latitude. In cases where the Contractor has caused loss, the Employer can argue that because of the use of the word "including", the expressly listed types of loss are in fact forms of direct loss that are thereby recoverable.

This approach has authority to commend it. In *Pegler Ltd v Wang (UK) Ltd,*[52] the relevant exclusion clause provided that:

"Wang shall not in any event be liable for any indirect, special or consequential loss, howsoever arising (including but not limited to loss of anticipated profits or of data) in connection with or arising out of the supply, functioning or use of the hardware, the software or the services…"[53]

Despite the use of the word "including", the court held that the clause only excluded losses falling under the second limb of *Hadley v Baxendale*. It was noted by Judge Bowsher QC that:

52 [2013] WASC 356, [96-97, 116].

53 (1986) 161 CLR 500, [16].

"The reference by the words in brackets to loss of anticipated profits does not mean that the exclusion effected by this clause includes all loss of profits: it is plain from the context that only loss of profits which are of the character of indirect, special or consequential loss are referred to."[54]

It is certainly arguable that a court would adopt the same approach when considering our proposed clause, so that, for example, losses of profits that could be classified as direct could be recoverable by the Employer.

Courts have interpreted similar consequential loss clauses in ways that emphasise the difference between those losses commonly thought to be direct and other forms of indirect loss. In *BHP Petroleum Ltd v British Steel PLC*,[55] Rix J considered the following consequential loss clause:

"Neither the supplier nor the purchaser shall bear any liability to the other…for loss of production, loss of profits, loss of business or any other indirect losses or consequential damages arising during and/or as a result of the performance or non-performance of this contract."

Rix J interpreted this clause quite radically by construing the clause to read "for loss of production, loss of profits, loss of business or indirect or consequential damages of any other kind", as his Honour found that the express heads of loss could not be construed as forms of indirect or consequential loss. However, Rix J's interpretation of this clause is somewhat unusual, albeit in favour of the Employer. We favour the use of our clause, which is less radical and, given the authority in *Pegler v Wang*, would permit the Employer to argue persuasively for recovery of those losses that could be classified as direct.

Given the unclear position under Australian law, parties must also ensure that an exclusion of liability clause is carefully drafted. Importantly, the clause should set out clearly and exhaustively expressed in detail those losses which are intended to be categorised as consequential. Where presented with a clause excluding liability for consequential loss, Owners must expressly state the categories of loss for which the Contractor will be liable. This essentially means that Owners will need to include a definition of Direct Loss which would identify losses that are within the contemplation of the parties, eg in a project financing of a power or process plant project this should include loss of revenue under a corresponding off take agreement. Clearly this will be difficult to negotiate, but this should be the starting position.,

Exclusion of implied warranties

Contractors often propose to exclude terms implied by law. A general exclusion may be expressed as follows:

The parties agree that the warranties in this clause and any other warranties expressed elsewhere in the contract are the limit of the Contractor's warranties and are to the exclusion of any implied warranties at law.

Despite such a clause, certain warranties cannot be excluded by contractual agreement.

Nevertheless, we would agree to the inclusion of such a clause excluding implied warranties only if the list of express warranties is comprehensive. These warranties will usually be project specific, but Employers should take great care to ensure that their ability to recover is protected.

54 [2000] BLR 218.

55 Ibid, 226.

56 Ibid, 227.

57 [1999] 2 Lloyd's LR 583.

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