

***Exclusive remedies,
liquidated damages,
the Prevention
Principle,
consequential loss and
implied warranties***



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Introduction

This paper sets out the legal principles that apply to key provisions in EPC Contracts, and focuses on those issues that Contractors raise in an attempt to limit their liability.

Contractors often raise various arguments concerning provisions relating to time and performance which, if accepted, can have serious consequences for an Owner'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
- no liability for consequential loss
- the exclusion of all implied warranties
- the deletion of provisions that attempt to obviate the effects of the Prevention Principle.

This position paper sets out the legal issues that Owners 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 EPC 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 Owners; 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. 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 Owner 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
- by arguing that the Owner 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, a penalty, then it will not be enforceable by an Owner. 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 Owner as a result of a delay to completion. The High Court of Australia has recently considered the doctrine of penalties and considered that equity and common law have a role to play in considering their validity. The court provided a wide definition of a penalty, stating:

“In general terms, a stipulation prima facie imposes a penalty on a party (the first party) if, as a matter of substance, it is collateral (or accessory) to a primary stipulation in favour of a second party and this collateral stipulation, upon the failure of the primary stipulation, imposes upon the first party an additional detriment, the penalty, to the benefit of the second party.”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 to the extent that it reflects appropriate compensation.² It makes no difference that the contract specifically states that the clause is not a penalty³ 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 generally 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.

¹ *Andrews v Australian and New Zealand Banking Group Ltd* (2012) 247 CLR 205, 216.

² *Ibid.*

³ *Jobson v Johnson* [1989] 1 WLR 1026; *Andrews v Australian and New Zealand Banking Group Ltd* (2012) 247 CLR 205.

⁴ *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor Co Ltd* [1915] AC 79, 86.

⁵ 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.

Time at large

If an Owner 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 the liquidated damages clause to be declared invalid or otherwise inoperative indicates the importance of failsafe clauses and other provisions which preserve an Owner’s rights to claim damages at law.

Removal of failsafe clauses for delay and underperformance

Failsafe provisions in EPC Contracts attempt to preserve the Owner’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 Owner from claiming Delay Liquidated Damages, the Owner 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 Owner’s sole entitlement for the Contractor’s delay or underperformance. As explained below, exclusive remedies clauses may prevent an Owner 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 Owner’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.

Exclusive remedies generally

Contractors typically attempt to insert a provision stating that the remedies expressly provided for under the EPC 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 Owner’s rights to those explicitly articulated in the EPC Contract. This potentially leaves the Owner without remedies for the Contractor’s breaches of the EPC Contract, as we explain below.

⁶ Keith Pickervance, ‘Calculation of a Reasonable Time to Complete when Time is at Large’, [2006] *International Construction Law Review* 167, 168.

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 Owner, while prevented from claiming liquidated damages, still has the right to claim damages at common law (or in equity it may have the right to enforce the clause to the level that represents appropriate compensation in the circumstances).

Exclusive remedies provisions exclude the ability of an Owner to claim common law damages in the event the liquidated damages regime is declared unenforceable, thereby restricting the Owner'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, ie if 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 so as to exclude common law rights to damages depends on the construction of each individual contract: *Turner Corporation Ltd (Receiver & Manager Appointed) v Austotel Pty Ltd*.⁷ 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.⁸

Courts in both England and Australia have held that clear wording may remove the common law right to damages. This view has been followed in a number of cases.⁹ In *Baese Pty Ltd v RA Bracken Building Pty Ltd*¹⁰ (**Baese**), Giles J stated that:

*"...it would require clear words...before it was held that a liquidated damages clause was the entirety of the proprietor's rights, because the proprietor would be exposed to being left with no entitlement at all to damages for delay if by reason of his own contribution thereto he was unable to rely upon the liquidated damages clause."*¹¹

This position has arguably been broadened by Australian courts, so that "clear words" does not necessarily mean "express words." In *Turner Corporation Ltd (Receiver and Manager Appointed) v Austotel Pty Ltd*¹² Cole J held that a party's rights to common law damages do not need to be excluded by express words; a general intention, surmised from the terms of the contract more generally, can be sufficient:

*If on the proper construction of the contract as a whole, it can be said that a party has surrendered its common law rights to damages, that construction must be given effect to, notwithstanding absence of express words surrendering the common law rights to damages.*¹³

7 (1994) 13 BCL 378.

8 *H W Nevill (Sunblest) v William Press & Sun* (1981) 20 BLR 78, 88; *Baese Pty Ltd v RA Bracken* (1990) 6 BCL 137.

9 See, eg, *Photo Production Ltd v Securicor Transport Ltd* [1980] AC 827 (Lord Diplock); *Hancock v Brazier (Anerley) Limited* (1966) 1 WLR 1317; *Billyack v Leyland Construction Co Ltd* (1968) 1 WLR 471; *H W Nevill (Sunblest) v William Press & Sun* (1981) 20 BLR 78; *Baese Pty Ltd v RA Bracken Building Pty Ltd* (1990) 6 BCL 137.

10 (1990) 6 BCL 137.

11 *Ibid*, 142.

12 (1994) 13 BCL 378.

13 *Turner Corporation Ltd (Receiver and Manager Appointed) v Austotel Pty Ltd* (1994) 13 BCL 378, [36] (Cole J).

This is an important and controversial statement of principle, as it 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 will have no remedies other than those specifically and particularly stated in the Contract. In *Temloc Limited v Errill*¹⁴ it was held that the words “Nil” in a damages annexure was evidence that the parties intended no liability for either liquidated or unliquidated damages.¹⁵ Nourse LJ noted that:

*“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.”*¹⁶

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 exclusive remedies clause will prevent the Owner from claiming common law damages for delay or underperformance in the event that the liquidated damages are declared invalid, it may have far reaching effects on other clauses of the Contract.

A typical comprehensive exclusive remedies clause is as follows:

The Owner 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 Owner’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 for, the Owner would not be able to recover damages from the Contractor for breaches of the 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 Owner 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 Owner will require contractual compliance. There will be numerous other Contractor obligations under the EPC Contract with which the Owner 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.

¹⁴ [1987] 39 BLR 30.

¹⁵ See also *CS Phillips Pty Ltd and Anor v Baulderstone Hornibrook Pty Ltd* [1994] 30 NSWSC 185 (26 October 1994).

¹⁶ [1987] 39 BLR 30, 39.

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 Owner 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.

Proposed solutions

One option is for an Owner 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 Owner 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 which the Owner may suffer as a result of the breach.

The preferable solution is to argue strongly against 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.

The operation of the Prevention Principle

Rationale

There are various rationales for the existence of the Prevention Principle. 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
- an implied term or implied supplemental contract¹⁷
- waiver or estoppels¹⁸
- 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 (see *Secured Income Real Estate (Australia) Ltd v St Martins Investments Pty Ltd* (1979) 144 CLR 596, 607 (Mason J) and *Spires Earthworks Pty Ltd v Landtec Projects Corporation Pty Ltd [No 2]* [2012] WASCA 54, [46]). In any case, the fundamental considerations are of fairness and reasonableness.¹⁹

¹⁷ *SBS International Pty Ltd v Venuti Nominees Pty Ltd* [2004] SASC 151, [11] (Besanko J).

¹⁸ [1987] 39 BLR 30.

¹⁹ *SMK Cabinets v Hili Modern Electrics* [1984] VR 391, 397 (Brooking J).

Operation

The operation of the Prevention Principle will ensure that an Owner will lose its right to claim liquidated damages for delay if that delay was caused by an act of prevention, where there is no extension of time clause which specifically provides for extensions due to acts of prevention. 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 Owner's act of delay, or where that power cannot be exercised in the circumstances.

What acts or omissions of the Owner bring the Prevention Principle into operation? Courts generally have regarded any wrongful act or fault as sufficient to enliven the principle.²⁰ It is not necessary that the act constitutes a breach of contract. The broadest view is that any act of the Owner, regardless of its fault element, is sufficient to engage it. Variations are regarded as acts of prevention for the purposes of the doctrine.²¹

In considering whether an extension of time clause provides for the granting of extensions of time for Owner caused delay, the extension of time clause will be construed *contra proferentem* against the Owner. 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 Owner," will not entitle the Owner to the benefit of the liquidated damages regime.²² Where the extension of time clause provides specifically for the Owner'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*:²³

*"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."*²⁴

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 remains unsettled in England as there has been no comprehensive consideration of the principle since the decision in *Alghussein Establishment v Eton College*²⁵. However, the case law in Australia remains divided. In *Gaymark v Walter Construction* (1999)²⁶ (**Gaymark**), 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.²⁷ Later cases have suggested that conditions precedent must be satisfied before the Prevention Principle can have

²⁰ Ian D Wallace (ed), *Hudson's Building and Engineering Contracts* (Sweet & Maxwell, 11th ed, 1994) vol 2, [10-040].

²¹ *SMK Cabinets v Hili Modern Electrics* [1984] VR 391, 397 (Brooking J); *SBS International Pty Ltd v Venuti Nominees Pty Ltd* [2004] SASC 151, [12].

²² Wallace, above n 20.

²³ (1970) 1 BLR 111.

²⁴ *Ibid*, 121.

²⁵ [1988] 1 WLR 587.

²⁶ [1999] 16 BCL 449.

²⁷ Ian D Wallace, "Prevention and Liquidated Damages: A Theory Too Far?" (2002) 18 *Building and Construction Law* 82.

application. Indeed, in *Turner Corporation Limited (Receiver and Manager Appointed) v Austotel Pty Ltd*²⁸ 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, because:

*“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.”*²⁹

A further question regarding the scope of the Prevention Principle concerns what is actually invalidated by the Owner’s act of prevention. If the Owner causes four days of delay to a program, and the Contractor is 100 days late in delivery of the project, can the Owner 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 Owner invalidated the entire liquidated damages regime. In *Holme v Guppy*³⁰ the delay in completion was five weeks; the Owner was responsible for four weeks of delay and the Contractor for one week of delay. The court found that the Owner was not entitled to any liquidated damages due to its act of prevention. In *Parle v Leistikow*³¹, the Contractor was responsible for a delay of 21 weeks. The total period of delay was 24 weeks. The Court found that, because there had been an act of prevention by the Owner (albeit only three weeks), the Owner was not entitled to any liquidated damages. In *Hudson’s Building and Engineering Contracts*, Wallace notes that:

*“[u]nless there is a sufficiently specific clause, it is not open to the Owner 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 Owner and, after crediting that period to the builder, to seek to charge him with damages at the liquidated rate for the remainder.”*³²

This view appears to be based on the needs of certainty and predictability, and finds its foundation in the classic case of *Peak Construction (Liverpool) Ltd v McKinney Foundations Ltd*.³³ More recent authority suggests that the Owner’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 v Ealing Family Housing*³⁴ 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.”*³⁵

*“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 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

²⁸ *Turner Corporation Ltd (Receiver and Manager Appointed) v Austotel Pty Ltd* (1994) 13 BCL 378, [11] (Cole J).

²⁹ *Ibid.*

³⁰ (1838) 3 M&W 387.

³¹ (1883) 4 LR (NSW) 84.

³² Wallace, above n 20, [10.025].

³³ (1970) 1 BLR 111.

³⁴ (1984) 29 BLR 5.

³⁵ *Ibid.*, 18.

³⁶ Above n 21, cited in Keith Pickervance, ‘Calculation of a Reasonable Time to Complete When Time is at Large,’ [2006] *International Construction Law Review* 167, 177.

³⁷ (1984) 29 BLR 5, 19.

In *SMK Cabinets v Hili*,³⁸ Brooking J stated that the Employer's act of prevention served only to prevent the Employer from taking liquidated damages that accrued after the Employer's breach.³⁹ While this view has much to commend it, the classic case of *Peak* remains dominant, and authorities seem to suggest that where an act of prevention goes to part of the delay but not the whole, the entire liquidated damages clause will be invalidated.⁴⁰ This traditional view has recently been reinforced in *SBS International Pty Ltd v Venuti Nominees Pty Ltd*,⁴¹ 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. Besanko J stated that:

*"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."*⁴²

To summarise, an Owner 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.

It is prudent to include a provision permitting the Owner 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 Owner, the Owner'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.

³⁸ [1984] VR 391.

³⁹ Ibid, cited in Keith Pickervance, 'Calculation of a Reasonable Time to Complete When Time is at Large,' [2006] *International Construction Law Review* 167, 177.

⁴⁰ Wallace, above n 20.

⁴¹ [2004] SASC 151.

⁴² Ibid, [12] (Besanko J).

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 Owner delaying the works.

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

- *Any principle of law or equity (including those which might otherwise entitle the Contractor to relief and the Prevention Principle) 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 Owner or any failure by the Owner or the Owner's Representative to comply with this Clause [] will not cause the Date for Commercial Operation to be set at large*
- Nothing in Clause [].2 will prejudice any right of the Contractor to claim an extension of time under this Clause [] or delay costs under [] 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 on 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."*⁴³ See to similar effect *Mason and Wilson JJ in AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170, 190.

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"* (see *Australian Securities and Investments Commission v Fortescue Metals Group Ltd* [2011] FCAFC 19 at [222]). 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.

This approach has found favour in a recent High Court decision relating to penalties.⁴⁴ Similar sentiment may apply to permit parties to contract out of the Prevention Principle. Exceptions from the doctrine of freedom of contract normally require an element of unconscionability or oppression. In *Ringrow Pty Ltd v BP Australia Pty Ltd*, the High Court of Australia noted that, *"[e]xceptions from that freedom of contract require good reason to attract judicial intervention to set aside the bargains upon which parties of full capacity have agreed."*⁴⁵ This authority suggests, by analogy, that the Prevention Principle can be excluded in contracts where the parties have expressly agreed upon their risk allocation in terms of time and money.

⁴³ *Philips Hong Kong Ltd v The Attorney General of Hong Kong* (1993) 61 BLR 49, 58.

⁴⁴ *Ringrow Pty Ltd v BP Australia Pty Ltd* (2005) 222 ALR 306, 314 (citing *AMEV-UDC Finance Ltd v Austin* (1986) 162 CLR 170 at 190).

⁴⁵ (2005) 222 ALR 306, 314.

However, recent developments in the law of penalties suggest a greater willingness of courts to examine the purpose with which certain contractual clauses purport to operate. For example *Andrews v ANZ*⁴⁶ states that a clause may be characterised as penal if it operates as a security to ensure that the primary obligation is performed. This differs from the statement in *Ringrow Pty Ltd v BP Australia Pty Ltd* where the court focused on the element of oppression or unconscionability.

Because the Prevention Principle is based on general principles of fairness, it could be argued that a provision in a contract allowing an Owner to recover liquidated damages as a result of its own delay may be viewed by a court as unconscionable. Indeed, a court may be inclined to ignore a provision which attempts to contract out of the Prevention Principle, and may instead regard such an attempt as a way of bypassing equitable principles on which the principle is built.

Similarly, it may be argued a provision which attempts to exclude the operation of the Prevention Principle may sound in a claim for restitution through the principle of unjust enrichment. An attempt to contract out of the Prevention Principle may lead a court to conclude that the Owner, by causing a delay that does not invalidate the liquidated damages regime, is thereby unjustly enriched. However, it is submitted that this view would not be considered persuasive.

First, it is submitted that the Prevention Principle is not a fundamental equitable principle, equivalent to established equitable principles. The more sound view is that the Prevention Principle could be contracted out of, subject to the absence of oppression or disadvantage – in which case, the doctrine of unconscionability may apply to impose an equitable remedy.

Secondly, a restitutionary claim would be unlikely to succeed based on the exclusion of the Prevention Principle. A claim that the exclusion of a clause, mutually agreed to by the parties (in most cases we presume a valid contract exists between the Owner and the Contractor in relation to the provision of the benefits), could be sufficient to unjustly enrich one party, to the detriment of another, would be highly unusual and an extension of restitutionary principle beyond currently elaborated boundaries.

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.

⁴⁶ *Andrews v Australian and New Zealand Banking Group Ltd* (2012) 247 CLR 205.

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
- 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 contractor was 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 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.

⁴⁷ (1854) 9 Ex 341.

⁴⁸ *Peerless Holdings Pty Ltd v Environmental Systems Pty Ltd* [2006] VSC 194. See also *Hotel Services Ltd v Hilton International Hotels (UK) Ltd* [2000] 1 All ER (Comm) 750.

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 "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 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

⁴⁹ *Peerless Holdings Pty Ltd v Environmental Systems Pty Ltd* [2006] VSC 194, [96-97; 116]; *Millars Machine Co Ltd v David Way & Son* (1934) 40 Com Cas 204; *Croudace Construction Ltd v Cawoods Concrete Products* [1978] 8 BLR 20.

⁵⁰ *GEC Alstom Australia v City of Sunshine* [1996] 170 FC 1 (20 February 1996); *Aquatec-Maxcon Pty Ltd v Barwon Region Water Authority (No 2)* [2006] VSC 117, [103].

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*,⁵¹ 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:

*“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*,^{55,56} 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

⁵¹ [1999] 1 Lloyd’s Rep 387.

⁵² (1986) 161 CLR 500.

⁵³ [2013] WASC 356.

⁵⁴ (2008) 19 VR 358.

⁵⁵ [2013] WASC 356, [96-97, 116].

⁵⁶ *MWH Australia Pty Ltd v Wynton Stone Australia Pty Ltd (in liq)* (2010) 31 VR 575, [87]-[88]; *Glenmont Investments Pty Ltd v O’Loughlin & Ors* (2000) 79 SASR 185, [247]-[273].

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 delete reference to warranties 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. For example, in Australia it is impossible to contract out of certain provisions of the Australian Consumer Law. Those provisions that are most applicable to EPC projects, such as section 18 on misleading or deceptive conduct, cannot be validly excluded. Further, a 'fitness for purpose' warranty will be implied despite a Contractor's desire to exclude it.

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 Owners should take great care to ensure that their ability to recover is protected.

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