Implied Terms in Building Sub-contracts - The Death of Sub-contractors' Prolongation, Variation and Disruption Claims?

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One of the banes of the life of head contractors in the building and engineering industry is the prolongation cost or disruption claim by sub-contractors.

A "prolongation cost" or "disruption claim" for the purposes of this article refers to a claim for extra expense, cost, loss or damage by a sub-contractor who is completing or has completed the sub-contract work.

Generally such claims are "time based". By that it is meant that the sub-contractor claims that the builder, as a result of some act, neglect or default on the part of the builder, has caused the sub-contractor to be delayed or has caused the sub-contractor to be on site longer than originally contemplated by the contractor, with more resources than was originally contemplated by the contract, and as a result the sub-contractor has incurred or suffered prolongation costs which the builder should pay.

This is commonly coupled with an allegation that, in the alternative, those costs should be recoverable on the basis of disruption of the work by the builder.

Alternatively there are often allegations that the works have been "varied" and extra costs should be recoverable.

To recover such prolongation costs sub-contractors normally have to show either:

1. A right to recover the costs pursuant to an express term in the sub-contract. Usually such an express term is coupled with an applicable time extension clause; or
2. A right to damages for breach of an express term of the contract. For instance the contract may entitle the sub-contractor to free and uninterrupted access to, and possession of, the site. The builder's conduct may breach such a right and consequently the sub-contractor may have a right to damages.
3. A right pursuant to an implied term of the sub-contract. The formulation of the exact language of such an implied term is by no means easy.
4. A right to damages for breach of an implied term in the contract. This is usually the pleader's last resort.

An immediate question raised is how such terms can be implied.

Similar claims are often made by builders on proprietors. There is in that situation usually a head contract document between the proprietor and the builder which they will have signed and which evidences their agreement. One therefore at least starts from a base of knowing what the parties agreed to in writing.

With sub-contractors that is not always so easy. The reason is that many builders (probably understandably) will often try to incorporate into their sub-contract identical terms to those appearing in the head contract so that the sub-contractor is bound to the same arrangement as the builder is bound to under the head contract. In fact many builders go so far as to make the terms imposed on the sub-contractor even more stringent than the equivalent head contract terms.

Rather than negotiate each term of the sub-contract the practice has developed of builders and sub-contractors seeking to incorporate head contract terms by reference by using phrases such as "all works to be carried out on the same terms and conditions as in the head contract" or "the terms of this subcontract are back to back with those of the head contract".

While superficially simple and obviously expedient such an approach is fraught with legal difficulties and dangers for the parties. That danger is often worsened by the builder seeking to impose such obligations on the sub-contractor by writing them on the front of a standard form purchase order which document itself may have terms on its reverse side which cover the same topics as the head contract terms and conditions. One may therefore find the purchase order tries to incorporate the head contract (including the arbitration clause appearing in the head contract) and at the same time that an arbitration clause appears on the back of the sub-contract. Which clause is to prevail?

In fact the builder and the sub-contractor may not even sign the documents but the sub-contract works may simply proceed with the works after an exchange of correspondence. This approach (commonly known as "the battle of the forms" in the standard contract texts) is unfortunately all too common in construction and engineering contracting.

Without having clearly defined which terms are to prevail, works may proceed and it is only at a later stage,

when a dispute occurs, that the parties actually turn their minds to what are the terms and conditions of the contract. This then becomes a contract lawyer's nightmare.

The nightmare is worsened when the sub-contractor asserts a right to recover prolongation costs. Where does one start in analysing such a situation?

Recent decision of *John Holland Construction & Engineering Pty Ltd v. World Services and Construction Pty Ltd*

Some of these matters were considered in decision in *John Holland Construction & Engineering Pty Ltd v. World Services and Construction Pty Ltd*, an unreported decision of His Honour Mr Justice Byrne (the Judge in charge of the Supreme Court Building Cases List in Victoria) handed down on 27 August 1993.

The facts

The defendant, World Services, had entered into a detailed written head contract (over 200 pages long) with Shell to carry out certain highly technical engineering works for Shell at its refinery at Corio, near Geelong. The head contract contained detailed provisions for the order and rate of performance of the works and for progressive completion and hand over of the works. Even so there were some matters which were not properly dealt with in the head contract such as the question of valuation of variations.

World Services engaged John Holland (pursuant to a sub-contract) to do certain civil engineering and fire proofing work as part of the project. The contract was of the "battle of the forms" type with no one single document having been clearly signed by the parties as embodying their terms.

Upon completion of the sub-contract works John Holland sued World Services claiming:

1. time extension for completion of the works;
2. prolongation costs;
3. money for variations;
4. damages for breach of certain implied sub-contract terms;
5. damages for breach of an alleged agreement to pay expenses
   incurred during suspension of the sub-contract works.

The prolongation costs claim was, in the plaintiff's statement of claim, primarily based on a detailed implied term.

On the face of the pleadings it appeared that there were a number of apparently discreet preliminary issues which could be determined by the court separately including:

1. What documents constituted the written proportion of the sub-contract?
2. What implied terms, if any, were implied into the subcontract as alleged by the plaintiff?

Mr Justice Byrne directed that these issues be determined as preliminary issues.

By the time of the trial of the preliminary issues the plaintiff and the defendant had agreed on what documents comprised the written sub-contract and the defendant agreed that the whole of the head contract document had been incorporated by reference into the sub-contract. This concession obviously placed the court somewhat on the horns of a dilemma as both parties were now maintaining that there was, in fact, a written agreement of some detail between them and both parties agreed on many of the written terms which were part of their contract but neither could agree on what those terms might mean in the context of the subcontract. That was now going to be a matter for construction of the sub-contract by a court on a different date.

The importance of the concession by the defendant, however, should not be underestimated. It meant that the court did not have open to it, in the face of the parties' express agreement, the course of finding that there was no written sub-contract agreement between the parties. As Mr Justice Byrne pointed out in his judgment this raised many other problems. For instance, for the purposes of the sub-contract did one merely delete the words "Shell" wherever they appeared in the head contract and substitute the words "World Services"? Did one then further delete the words "World Services" wherever they appeared in the head contract and substitute the words "John Holland"? In some cases that led to some apparently absurd results. These were now difficult questions of construction of the head contract, when it was assumed into the sub-contract, and which would have to be dealt with on another day.

As the parties now seemed to have agreed the first question the court now had to consider the second question and that was whether the sub-contract contained any or all of the implied terms alleged by the plaintiff.

The plaintiff could not point to any express term of the subcontract which entitled it to recover prolongation costs. Nor could it immediately point to a breach of an express term. The first two bases for recovering prolongation costs (as listed above) were therefore not open to the plaintiff.

The formulation of an implied term pursuant to which the plaintiff could recover prolongation costs was such a complex exercise that it was eventually abandoned by the plaintiff at the hearing. That disposed of the third basis for recovering such costs.

The plaintiff therefore had to imply other terms into the subcontract, the breach of which gave rise to rights to sue for prolongation costs.

The plaintiff was left with the following:

(a) Certain implied terms relating to delay, those implied terms being:
   (i) an implied term entitling the plaintiff to claim time extensions;
   (ii) an implied term requiring the defendant to grant time extensions;
   (iii) an implied term which in the event of the defendant not granting a time extension, required the defendant to pay the plaintiff's extra costs of adhering to the original program;

(b) Implied terms relating to variations and the valuation of variations.
(c) Implied terms relating to cooperation between the parties including:
  (i) a term that the defendant would administer, coordinate and program the head contract works and the sub-contract works so as not to cause delay, loss or damage to the plaintiff;
  (ii) a term requiring the defendant to provide sufficient access to the works, to provide information to the plaintiff, and to do all things necessary on its part to enable the plaintiff to carry out its obligations under the sub-contract and not to frustrate the plaintiff in carrying out its work.

The above terms were said to be implied as a result of:
(A) the written specific express terms in the head contract;
(B) the conduct of the parties;
(C) the plaintiff's performance of the work;
(D) the defendant's payment of the plaintiff for the work;
(E) from the need to give business efficacy to the subcontract; and
(F) from the conduct of the parties after the date the subcontract was entered into and during the performance of the works.

This last base (F) for implying a term was ultimately not pursued by the plaintiff.

Implied terms relating to delay

His Honour found that in the light of the express written terms of the head contract which were agreed by the parties to be part of the sub-contract, such terms could not be implied.

His Honour drew the distinction between terms implied by law so as to give legal incident to the contract on the one hand and terms implied by law to give business efficacy to the contract on the other hand. The terms to be implied here were in the second category.

His Honour set out the well known test for implying terms laid down by the High Court in *Codelfa Construction Pty Ltd v. State Rail Authority of New South Wales* (1982) 149 CLR 337 at 345 which were as follows:

1. The term must be reasonable and equitable;
2. The term must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it;
3. The term must be so obvious that "it goes without saying";
4. The term must be capable of clear expression; and
5. The term must not contradict any express term of the contract.

The three proposed terms certainly met the first test. None of the terms, however, satisfied the second test. The work had in fact been finished two years ago without the benefit of such a term. It was not enough for the term to be merely reasonable.

The third and fourth tests were not satisfied. It was quite possible to formulate terms within the spirit of the corresponding clauses of the head contract which achieved a different result and which were still reasonable. In the words of His Honour "the possibility that different formulations of the term can reasonably be made is to my mind fatal to an implication in the present case...". Authority for that proposition was *Trollope and Coles v. North West Metropolitan Regional Hospital Board* (1973) 2 All E.R. 260.

Further, another factor which weighed on His Honour's mind was the fact that a term implied to entitle the plaintiff to claim time extensions is usually inserted in a contract for the benefit of the proprietor - see *Peak Construction (Liverpool) Ltd v. McRinney Foundations Ltd* (1970) 1 BLR 111. Such clauses are construed against a proprietor since their purpose is traditionally seen as being to save the proprietor's liquidated damages clause. "In these circumstances the court should be particularly slow to imply a term dealing with this matter".

Implied terms relating to variations

The plaintiff sought to imply a detailed term giving rise to a right to the defendant to require the plaintiff to carry out variations and then providing for the procedure for the valuation of variations so carried out. The term, when articulated so as to fit into the framework of the contract, was nearly a page long.

Reference was made to the decision of the High Court in *Leibe v. Malloy* (1906) 4 All E.R. 347 where a contractor who carried out work at the direction of an architect who refused to give a written order as required by the contract was entitled to payment of a fair and reasonable sum, despite a clause prohibiting payment for work performed without an order in writing. His Honour proffered the view that since the High Court's decision in *Pavey & Matthews Pty Ltd v. Paul* (1987) 162 CLR 231, Leibe v. Malloy might be seen as an example of a right to restitution. In any event the implied promise to pay in *Leibe v. Malloy* is not an implied term of the contract but a promise outside of the contract.

The head contract itself was deficient in dealing with variations. It did not clearly set out a method for valuing variations or what was to happen if the variation procedure was not followed. The John Holland suggested implied term sought to cure this limitation.

Again His Honour said "I cannot, however, arrive at this result however reasonable, by implying a term to that effect and I will not impose upon the non consenting World Services such a term on the basis merely that it is reasonable".

Implied terms as to cooperation

As to the term for World Services to administer, coordinate and program the head contract works and the sub-contract works in a particular way His Honour noted that it was not the function, under the head contract, for World Services to administer coordinate and program the head contract work. It was World Services' function to perform the works in accordance with the contract. The administration, coordination and programming of the sub-contract works could equally depend upon World Services or Shell, depending on what was involved.

As His Honour noted:

> "There is authority for the view that each party to a contract has an implied duty to cooperate in the performance of acts which are necessary to the performance by them or one of them of the fundamental obligations under the contract ... and possibly not to exercise a contractual power unreasonably ... no case however was cited to me in support of a principle as contended for by John Holland ..."

As noted by His Honour:

> "If there is to be a contractual constraint on the performance by World Services of its functions under the sub-contract of the kind proposed, this constraint must emerge from the terms of the sub-contract itself.

It was not something a court could imply into the contract.

His Honour expressly noted that he was not dealing, in this case, with construction of the head contract terms but purely with the question of implied terms and whether they could be implied. As to site access, His Honour recognised that there might, in the absence of an express term, be an implied term providing for World Services to be under an obligation to give access, sufficient in nature and in time, to enable John Holland to carry out its sub-contract within the time frame imposed on it. This was a much narrower formulation than the term that was proposed by the plaintiff in this case.

In the circumstances His Honour was not able to conclude that the sub-contract contained the implied term proposed by the plaintiff.

His Honour concluded as follows:

> "It may be, and I express no view on this matter since it was not argued before me, that it would be possible, as a matter of construction (of the head contract) in the circumstances of a particular claim, so to construe the documents which constitute the sub-contract as to conclude that a term such as one or other of those proposed is in fact an express term of the sub-contract."

The court was not, however, prepared to imply such terms.

The future

This decision will cause sub-contractors claiming on builders (and indeed builders claiming on proprietors) for prolongation costs, variation costs and disruption costs to work flow to have to fundamentally reassess their approach.

One has to carefully consider what documents constitute the contract. If these can be agreed upon or otherwise identified with precision, one has to query whether there will be any scope to imply the sort of implied terms which have bedevilled the construction industry in recent times.

In the absence of express terms entitling a party to recover such costs, or a construction of the express terms which allows such costs to be recovered as damages for breach of the express terms, the courts will be slow to imply such terms into the contract merely to assist the aggrieved party, no matter how fair or reasonable that may appear to be.

Parties will have to expressly and carefully negotiate their own bargains, and not leave it to the courts to fill the gaps subsequently.