ANALYSING RECENT DEVELOPMENTS IN RELATION TO RISK

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INTRODUCTION

Risk management has become increasingly important for nearly all commercial organisations operating in today's environment, but perhaps no more so than for companies involved in major mining, civil or construction projects, where failure to accurately identify and make appropriate allowance for risks being assumed under complex commercial and contractual arrangements can have dire consequences. In recent times there have been many examples of such consequences and the fallout which may result in the event that risk is not carefully managed. This fallout can extend beyond the immediate parties to the construction project and can have political and social impacts extending from public hostility to future projects right through to the burden placed upon judicial resources, as a result of the inevitable disputation that can arise as a result of risks and projects spiralling out of control. This paper will provide an overview of risk in construction projects and the methods adopted by various stakeholders to manage that risk in an always dynamic environment.

Managing risk—Ideology and practice

Consideration of the No Dispute report prepared by the NPWC/NBCC joint working party in May 1990[1] is a logical starting point for an analysis of risk management in major construction projects.

That working party considered that the basic principles of allocating obligations and/or risks for all projects should be those expounded by the international construction lawyer Max Abrahamson and are referred to as 'the Abrahamson Principles'. Those principles suggest that a party to a contract should bear a risk where:

- the risk is within the party's control;
- the party can transfer the risk, e.g. through insurance, and it is most economically beneficial to deal with the risk in this fashion;
- the preponderant economic benefit of controlling the risk lies with the party in question;
- to place the risk upon the party in question is in the interests of efficiency, including planning, incentive and innovation efficiency; and
- if the risk eventuates, the loss falls on that party in the first instance and it is not practicable, or there is no reason under the above principles, to cause expense and uncertainty by attempting to transfer the loss to another.[2]

These principles have not already translated into practice however, as a decade later, a study of major construction contracts in Western Australia found:

- risks were not allocated to the party best able to manage the risk;
- formal risk assessments were not being undertaken;
- risk clauses varied from those in standard contracts;
- risks were transferred to consultants and contractors which were impossible for them to manage;
- risks were not costed in tenders;
- cost savings would have occurred had risks been more effectively allocated;
- the implications of changing risk allocation were not known; and
- disputes and claims increased as a consequence of changes to risk allocation.[3]

Perhaps more hopeful are the results of a more recent survey undertaken by the School of Construction Management and Property at the Queensland University of Technology of senior management involved in the Queensland construction industry concerning the usage of risk management techniques, which indicated that:

- the use of risk management is moderate to high, with very little differences between the types, sizes and risk tolerance of the organisations, and experience and risk tolerance of the individual respondents;
- risk management usage in the execution and planning stages of the project life cycle is higher than in the conceptual or termination phases;
- risk identification and risk assessment are the most often used risk management elements ahead of risk response and risk documentation;
- brain storming is the most common risk identification technique used;
- qualitative methods of risk assessment are used most frequently;
- risk reduction is the most frequently used risk response method, with the use of contingencies and contractual transfer preferred over insurance; and
- project teams are the most frequent group used for risk analysis, ahead of in–house specialists and consultants.[4]

Multidisciplinary approach

The use of a project team to undertake risk analysis appears to be one of the key trends to have emerged in recent years and it is clearly necessary to take a holistic approach that focuses not only on legal risks but the myriad technical, commercial, regulatory and process risks likely to be encountered. Accordingly a legal 'risk assessment' is likely to comprise only one aspect of assessments which should be made, involving a variety of professionals drawn from other disciplines, both in–house and sometimes externally.

Risks which the various stakeholders consider as most significant to them will guide their focus on risk management, the allocation of those risks and their choice of disciplines called upon to inform their decision making process.

The perception of risk—what constitutes a risk in the first place and the reaction of a particular stakeholder to it, will often be informed by past experiences and influenced by value systems—both personal and organisational. Hence, a contractor in a competitive tendering situation may feel that it is being asked to assume risks over which it has no control, while at the same time the principal may consider that those risks have been allocated to the party best able to manage them.[5] The financier, on the other hand, its perception of risk being driven by the nature of the financing itself and the focus on completion risk, may seek to allocate maximum risk to the contractor for the good of cash flow—insisting on an allocation of risk even more narrow than that which might otherwise have been negotiated between industry participants.

EMPLOYING EFFECTIVE RISK MANAGEMENT STRATEGIES FROM PROJECT INCEPTION THROUGH TO CONTRACT AWARD AND IMPLEMENTATION

Risk management involves the identification, mitigation and evaluation of risks[6]. The Standards Australia standard on Risk Management has defined Risk Management as 'the culture, processes and structures that are directed towards realising potential opportunities whilst managing adverse effects' and the Risk Management Process as 'the systematic application of management policies, procedures and practices to the tasks of communicating, establishing the context, identifying, analysing, evaluating, treating, monitoring and reviewing risk'.[7] While the standard specifies the elements of the risk management process, it does not seek to enforce the uniformity of risk management systems and is independent of any specific industry or economic sector. Notwithstanding, this it has increasingly formed the basis for the more sophisticated forms of risk assessment undertaken by parties to major construction projects and sets out the base parameters of the risk management process.

Establishing the context

Prior to the identification of the key significant categories of risk, it is firstly important to establish the context within which those risks must be managed and to set out the scope for the rest of the risk management process. The context will include the organisation's external and internal environment and the purpose of the risk management activity which will also include consideration of the interface between the external and internal environments. Clearly the context will vary dependent upon which stakeholder (i.e. principal, contractor, financier, insurer, or end user) is undertaking the risk management process.[8]

For example, a contractor being asked to submit a tender for a particular project can only do so in the context of its corporate goals and objectives, its particular tolerance for risk, and the external environment in which it is operating. Often times the internal context will be established and documented in tendering and corporate risk guidelines which any proposed project will then be gauged against.

The external environmental may be more variable. In buoyant economic conditions, a contractor may take the view that it does not wish to procure contracts with a contract value of less than a certain figure and will only proceed to bid when it can achieve a particular margin. Given a scarcity of resources and the opportunities available in other areas of its business, it may also determine not to tender for projects that fall outside of its direct area of expertise. Similarly, it may be in a position to insist upon strict compliance with its own internal guidelines in relation to the level of contractual and financial risk it is prepared to assume on the project before it is prepared to 'walk away'.

This context might be contrasted with that in which the contractor may find itself once boom conditions dissipate—work may be undertaken for a lower margin and at greater assumed risk in areas in which it has less expertise, in order to support an enlarged labour force and head office overheads.

Identifying key significant categories of risk

Having established the context, the task of actual identification of risks needs to be undertaken. Risk identification itself is often undertaken through a variety of methods which may include check lists, brainstorming, corporate experience (or drawing upon consultants or subcontractors who have experience in the particular industry segment), site visits, analysis of prior projects, the use of organisational charts to review internal structures and flowcharts to review process issues and through research, interviews and surveys of parties likely to be impacted by the proposal. Ultimately the aim is to generate a comprehensive list of sources of risks and events that might have an impact on the achievement of each of the objectives identified in the context. These events might prevent, degrade, delay or enhance the achievement of those objectives.

There are also a multitude of risks which could emerge at any stage of a project and while these will require constant monitoring, management and treatment, at some juncture the process of risk identification needs to be finalised in order to progress through the balance of steps in the risk management process.

Accordingly the main objective is to see that the major risks that could impact on the project most adversely are not left unidentified. Most commonly a relatively small percentage of key risks are likely to account for the majority of the time and cost implications of the entire risk.

Categories of risk

Due to the various nature of risks which may be encountered in a major project and the differing weights which may attach to their consequences (and differing 'treatments' which may ensue), it is not uncommon for parties to seek to identify these risks under major headings or categories, including attempts to break the risks down into commercial (business or project pre–requisite and sustainability) risks, construction (and/or operational) risks and third party (act of God/Government) risks—often each with their overlay of 'legal risks'. In the writer's view, one of the dangers of slavishly adopting such an approach is that it can tend to reinforce an assumed allocation of risk dependant upon the project delivery method being proposed and the respective interests of the various stakeholders.

By way of example, a contractor assessing the risks involved in bidding on a straightforward 'construct only' commercial office tower project, may assume that so called 'project risks', such as the availability of requisite planning approvals or the principal's financing are matters solely the concern of the principal and accordingly focus on so called 'construction risks' such as the impact of latent conditions, risks of delay etc. This would be a mistake however, for while contractors, principals and financiers will each attach varying levels of importance to various risks, a consideration of the totality of risks which may be encountered is essential in order to determine their impact and 'knock on' effect.

To use the above illustration, while the funding risk might be seen as a risk primarily relevant to the principal's ability to get the project 'off the ground' and subsequently one borne by the principal and financier through to completion, the 'knock on' effects of the funding arrangements can be very significant from the contractor's point of view, for reasons we will consider in some detail shortly.

Accordingly, it is suggested that it is wise for each of the stakeholders to consider each and every risk which they identify as being relevant to the project as a whole, and thereafter seek to categorise those risks by the manner in which they are proposed to be 'treated', rather than seeking to 'fit' risks into general categories or even more alarmingly seek to allocate them at the outset to the respective stakeholders as matters of concern for the other project participants.

The timing and scope of the risk assessment undertaken will also necessarily be dependent upon the involvement of the respective parties at the various stages of project and product life cycle—concept and feasibility, design, construction, commissioning and handover, operation and maintenance, decommissioning and disposal. Clearly the type and intensity of an assessment of the operational phase of a facility undertaken by a contractor will vary dramatically between a contractor involved under a standard 'construct only' contract, and one in which the contractor has assumed on–going contractual responsibility for operation and maintenance.

Key areas of risk

The key areas of risk for a principal are different to those applying to a contractor and different again from those applying to a financier. The principal is generally concerned that the project will be:

- feasible, in the sense that the project will 'stack up' financially;
- able to proceed, in the sense of having obtained requisite site, planning and other approvals;
- able to be completed within budget (or allowed contingency) and on time having regard to the timing of end user requirements;
- able to satisfy end user requirements; and
- fit for purpose, in the sense of it meeting design, construction and performance criteria.

On the other hand, the contractors' key concerns are generally:

- to be paid in accordance with the terms of the contract including any additional amounts owing due to variation etc;
- to achieve its aimed for margin;
- to complete in accordance with its program;
- to have had the contract fairly administered; and
- to have avoided liability to third parties or the principal, e.g. liquidated damages etc.

A financier of the project will have other key areas of risk which differ again although there may be varying degrees of overlap. Completion risk, being the risk that the project will not be completed or not completed on time or at the anticipated cost translates into the risk for the financier that insufficient cash flow will be generated such that it may trigger default under the particular or a broader funding facility.

Other risks considered in project financing include:

- resource or reserves risk;
- security of tenure and political risk;
- raw materials and supplies risk;
- operating risk;
- market risk;
- financial risk;
- force majeure risk.[9]

Other heads of risk in the construction industry which may be of concern (to varying degrees) for all stakeholders include:

- damage to persons, property or works;
- contractual;
- design/construction;
- operating;
- financial and funding;
- construction performance;
- design;
- compliance with legislative requirements;
- workplace health and safety;
- environmental;
- cultural heritage;
- taxation;
- currency;
- change in government;
- political;
- site conditions (e.g. latent conditions);
- site access;
- technology;
- supply;
- force majeure;
- interface;
- inclement weather;
- industrial relations;
- legal (change of legislation);
- insurance;
- disputation;
- insolvency;
- consumption;
- safety;
- escalation; and
- interpretation.

Differentiating between risks that are and are not within the contractual parties' control

Having identified the key risks likely to be faced by the stakeholders in a major project, it is important to differentiate between risks that are and are not within the respective parties' control. The reason for this are self–evident if one accepts the soundness and desirability of seeking to allocate risks in accordance with the Abrahamson principle, i.e. the decision as to whether or not a party should ideally bear a risk will be in part a consequence of the determination of whether that risk is one within the party's control.

If one is to assume that 'bad' risk allocation (in the sense of a party being required to assume a risk over which it has no control or for which it is not adequately compensated or motivated to assume that risk) lies at the heart of much of the expensive and time consuming litigation and disputes which arise out of construction projects, the necessity to accurately assess which risks do or don't fall within a party's control becomes clear. There are however other important consequences which may flow from the inability to correctly identify which risks do or don't fall within a party's control including:

- The bankability of the project (i.e. a project financier may be unhappy to proceed if it feels significant risks are being borne by a project participant who may not have the wherewithal nor ability to control that risk).
- The principal paying an inflated price for the project as a result of loading unnecessarily (from the principal's point of view) built into the tender prices as a result of the tenderers being asked to price a contingency over which they have no control.
- The ability of that party to procure the requisite and appropriate insurance or even to determine whether insurance is required with respect to a particular risk or whether that risk is better managed via that party's internal risk management processes.
- The inability to determine which risks should be shared: risks that are outside of the control of both contractual parties may be ones best shared—for example the risk of inclement weather may be one agreed to be borne by the principle in a time sense but in a cost sense will be the contractor's risk. Shared risks outside of the control of each party with financially significant consequences may also be ones transferred to a third party, such as an insurer, in order to provide balance sheet protection.

Conducting an effective and accurate assessment of risk (analysis and evaluation)

Risk analysis is about developing an understanding of the risk. It involves consideration of the sources of risk, their positive and negative consequences and the likelihood that those consequences may occur. The purpose of risk evaluation is to make decisions, based on the outcomes of risk analysis, about which risks need treatment and treatment priorities. Risk treatment involves identifying the range of options for treating risks, assessing those options and the preparation and implementation of treatment plans.

There are two features that characterise risks:

- the probability (chance) by which they can happen; and
- their ultimate impact on the project, if they do materialise.[10]

An accurate assessment of these two aspects will enable an organisation or consortium to decide on a course of action.

The probability of a risk occurring and its impact on a project are used in tandem as decision aids. For example, if the chance of a risk happening is assessed to be high and its potential impact is equally high, than such risk is accorded high priority.

The table below demonstrates a prioritisation of risks where a risk designated '5' is accorded utmost priority, given that both its probability of occurring and its impact are both high.[11]

A delay in obtaining a mining lease, may for example be rated '5' particularly if the delay has 'flow on' effects to the contract mining program which may be significantly delayed by the wet season if operations are not able to be commenced before a certain date.

On the other hand a possible shortfall in reinforcing 'trumpets' for a silo project might be rated '1' as the ability to quickly procure equivalent replacements would not unduly delay the project.

Risk prioritisation matrix

Probability			
High			5
Medium		3	
Low	1		
	Low	*Medium*	*High*
		Impact	

Once these priorities are determined an assessment needs to be made. Such assessments are usually either qualitative, semi–quantitative or fully quantitative.

In a qualitative assessment both probability and impact are assessed subjectively. In practice, qualitative analysis is often used first to obtain a general indication of the level of risk and to reveal the major risk issues. Later it may be necessary to undertake more specific or quantitative analysis on the major risk issues. Qualitative analysis uses words to describe the magnitude of potential consequences and the likelihood that those consequences will occur. In semi–quantitative analysis, the objective is to produce a more expanded ranking scale than is usually achieved in qualitative analysis with probability being assessed subjectively but impact assessed objectively. In quantitative analysis numerical values for both consequences and likelihood using data from a variety of sources is undertaken. The quality of the analysis depends on the accuracy and the completeness of the numerical values and the validity of the models used. Consequences may be determined by modelling the outcomes of an event or set of events, or by extrapolation from experimental studies or past data.[12]

Risk evaluation involves comparing the level of risk found during the analysis process with risk criteria established when the context was considered. Which ever way the risks are evaluated, some form of sensitivity analysis is often conducted to identify the most volatile risks, i.e. those that have a knock on effect on the achievement of the project's objectives. In sensitivity analysis, therefore, cumulative influence of the risks on the project's objectives is assessed.

Treatment of risks

Treatment options for risks having positive and negative outcomes can be similar although the interpretation and implications are clearly different. Often the consequences of both positive and negative outcomes can be dealt with by way of risk sharing and a 'pain/gain' model commonly seen in forms of alliance and relationship contracting. Where dealing with negative outcomes from risks identified and having to treat those risks in the context of a more traditional contract structure, risk mitigation is called into play, this being the process of finding solutions to counter risks. Instead of simply pricing for risks there are other opportunities for mitigating risks including:

- risk elimination (e.g. not proceeding or proceeding on a different basis);
- risk reduction (e.g. by undertaking further investigations/due diligence);
- risk transference (e.g. by legal, contractual and insurance); and
- risk retention (e.g. self insurance, bearing a large deductible, internal management of risk).[13]

Often these mitigation strategies, particularly risk transference, are given effect contractually via the use of such means as contractual exclusions, limitations of liability, indemnity clauses, risk transference, guarantees, performance bonds and insertion of a risk premium.

EXPLORING LIABILITY CAPS AND LIMITATIONS, EXCLUSIONS OF CATEGORIES OF LOSS AND MANAGEMENT OF PROCESS RISKS

Exclusion clauses and liability caps

There is a distinction between an exclusion clause, the effect of which is to either absolve a party for the consequences of a breach of duty or to define substantively the limit of the duty by negating obligations that the law would otherwise impose[14] and a liability cap, the purpose of which is to limit a party's exposure up to a predetermined amount or percentage of contract value.

Often, these legal mechanisms operate in tandem with provisions in relation to liquidated damages (which is not considered to be exclusory, operating in theory for the benefit of both parties) and insurance and indemnity provisions within a contract, to create a finely balanced risk regime.

Such clauses are construed '... according to their natural and ordinary meaning, read in 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, and where appropriate, construing the clause contra proferentum in case of ambiguity...' [15]

Many contractors rely on such clauses to manage their risk of damages arising out of the performance of contracts they enter into—particularly in significant process engineering and mining contracts where exposure to unlimited damages will be often unacceptable. If the starting point is that a contractor will not accept liability for unlimited damages, a number of different outcomes can be achieved by adoption of appropriate exclusions, limitations or caps. Accordingly it is not uncommon to now see clauses drafted to ensure that liability for all damages is capped at a percentage of the contract sum or an annual amount in the case of a mining or services contract.

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Other than in respect of a provision for liquidated damages (which itself is likely to be capped at a percentage of the contract sum) the contractor may insist upon a complete exclusion for damages for loss of profit, loss of use and business interruption, or alternatively seek to cap any such exposure to the limit of any applicable insurance.

Process engineering and process design risks are of real concern given the potential for loss to the client over life of plant, from shortfalls in production in the event that the plant is unable to meet prescribed performance criteria. Accordingly a contractor will commonly seek to cap its total liability for a shortfall in production to the lesser of a percentage of the contract value or a fixed dollar amount.

Often the principal will insist upon exemptions of particular matters or losses when faced with a blanket exclusion. If the contractor agrees to this, it will often only do so, on the basis of a further cap on liability in respect of the matters not subject to the blanket exclusion.

Consequential loss exclusions in process engineering contracts

In a number of recent cases, a party who has contracted for the design and installation of plant and equipment, has sought to take the benefit of exclusion clauses in their contracts in defence to claims arising out of the performance of that plant or equipment.

Often these exclusions of liability seek to exclude any entitlement by the principal to pursue recovery in relation to what has been generically referred to as 'indirect' or 'consequential' loss. There have been some recent decisions by the English and Australian courts which are likely to impact upon the interpretation of these clauses and suggest avenues of recovery, notwithstanding their inclusion in contracts of this nature.

In *British Sugar PLC v NEI Power Product Ltd & Anor*,[16] the defendant faced a claim for increased production costs and loss of profits due to the breakdown of power supply caused by allegedly poorly designed and badly installed electrical equipment. The court held that the increased production costs and loss of profits flowed directly and naturally from the alleged breach and were therefore not consequential.

Similarly, in *Deepak Fertilisers & Petro Chemical Corporation v Davy McKee (London) Ltd & ICI Chemicals and Polymers Ltd*,[17] the English Court of Appeal decided that fixed costs and overheads claimed were not indirect or consequential—they were the direct and natural result of the destruction of the plant and had not been excluded elsewhere in the clause.

In *BHP Petroleum Limited v British Steel & Dalmine*,[18] the claim against British Steel alleged that losses had been caused because the inability to use the pipeline supplied until it was replaced had serious consequences for the way in which fuel operations were carried out, requiring significant expenditure on installing additional facilities and modifying existing equipment or necessitating flaring of gas which would otherwise have been re–injected. It was also claimed that the rate of extraction of both oil and gas was lower that it would otherwise have been—leading to the postponement of the exploration of the field's potential.

British Steel relied upon an exclusion clause in the following terms:

> *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 regardless of the clause thereof but not limited to the negligence of the parties seeking to rely on this provision.*

The court found that most of the losses claimed were in fact a loss of production and therefore covered by the express wording of the exclusion. However, it went on to consider what the position would be if it was wrong in this conclusion and became necessary to decide whether the losses were indirect or consequential.

As drafted, the exclusion clause appeared to imply that 'the loss of production', 'loss of profits' and 'loss of business' were examples of indirect losses or consequential damages. This led to the argument on behalf of BHP that only indirect and consequential losses of profits, production or business were excluded. If this submission had been accepted, the effect of the exclusion would have been severely limited because the losses of profits, production or business were likely, in the light of previous authorities, to have been considered direct losses, not merely consequential, and therefore not excluded.

It has been suggested (Rowe & Maw 'Consequential and indirect Loss' that the judge adopted a somewhat charitable approach to British Steel by deciding that the best solution was to construe the clause as though it read:

> *[F]of loss of production, loss of profits, loss of business or indirect losses or consequential damages of any other kind.*

These cases accordingly suggest that fixed costs and overheads, increased production costs, and sometimes even 'loss of profits' claims will not be excluded by consequential loss exclusions commonly found in a number of the standard form contracts and upon which contractors have traditionally relied.

This would seem to be borne out by some further recent decisions (albeit in a slightly different context).

In *Hotel Services Ltd v Aitton International Hotels (UK) Ltd*,[19] loss of profits resulting from defective products (and their removal and replacement) was held to be direct and natural consequence of the breach of contract.

The case of *Pegler Ltd v Wang (UK) Ltd (No 1)*,[20] seemed to widen the scope of losses claimable as 'direct and natural losses'. Loss of sales, loss of opportunity to increase margins, loss of opportunity to make staff cost savings and wasted management time were all considered to flow directly from the breach and were recoverable.

The most recent leading Australian Authority is the case of *GEC Marconi Systems Pty Ltd v BAP Information Technology Pty Ltd*,[21] in which losses to a third party such as the cost benefit of a head contract (lost future profits) and increased project costs were considered by Finn J of the Federal Court to fall within the first limb of *Hadley v Baxendale*,[22] and thus were recoverable as directly resulting from the breach.

As a result of the characterisation of damages in this manner and the interpretation and efficacy of a number of so called 'consequential loss' exclusions, a number of contractors are now no longer drawing a distinction between 'direct loss' and 'indirect or consequential loss' but are rather seeking to exclude specific types of damages (e.g. demurrage, currency fluctuations etc).

LIQUIDATED DAMAGES—RECENT AUTHORITIES ON THE LAW OF PENALTIES

An area of considerable financial risk for a contractor is the exposure to a principle seeking to levy liquidated damages. A common basis for attack by a contractor on an otherwise 'operative' liquidated damages clause is by arguing that the provision is penal in nature. The law of penalties is attracted where a contract stipulates that on breach of the contract, the party in breach will pay an agreed sum which exceeds what can be regarded as a genuine pre–estimate of the damage likely to be caused by the breach.[23]

As a rule of thumb, a clause which seeks to impose liquidated damages will be upheld, provided it is a genuine pre–estimate of damages—the time to assess whether the provision is compensatory or penal is the time when the parties entered into the transaction. In practice, successful attacks on the average liquidated damages clause in a contract are rare. It is only if the amount sought to be imposed is so far in excess of the maximum conceivable as to be out of all proportion, that it is likely to be construed as a penalty.

There are two recent Australian cases considered below which relate to a challenge to the validity of a liquidated damages clause based upon the clause in each case being a penalty.

Ringrow Pty Ltd v BP Aust Pty Ltd [2005] HCA 71

In *Ringrow Pty Ltd v BP Australia Pty Ltd*[24] the High Court considered the law of penalties and confirmed that it was proper to proceed on the basis that

Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd[25] continues to express the law applicable in relation to penalties in Australia.

The starting point for the appellant in that case was the following passage in Lord Dunedin's speech at pages 86–87:

2. the essence of a penalty is a payment of money stipulated as in terrorem of the offending party; the essence of liquidated damages is a genuine covenanted pre-estimate of damage ...

3. the question whether a sum stipulated is a penalty or liquidated damages is a question of construction to be decided upon the terms and inherent circumstances of each particular contract, judged as at the time of the making of the contract, not as at the time of the breach ...

4. to assist this task of construction various tests have been suggested, which if applicable to the case under consideration may prove helpful, or even conclusive. Such are:

(a) it will be held to be a penalty if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach ...

(b) it will be held to be a penalty if the breach consists only in not paying a sum of money, and the sum stipulated is a sum greater than the sum which ought to have been paid ...

(c) there is a presumption (but no more) that it is a penalty when 'a single lump sum' is made payable by way of compensation, on the occurrence of one or more or all of several events, some of which may occasion serious and other but trifling damage.

Paragraph 1 of the arguments relied upon by the appellant in the case before the High Court in Ringrow,[26] rested on a concept of proportionality which it was argued the option deed in that case contravened, in calling for a reconveyance of certain property after termination of an agreement rather than a lease for the balance of its term.

In rejecting the 'proportionality' doctrine contended for by the appellant, the High Court noted the words employed by Mason and Wilson JJ in *AMEV–UDC Finance Ltd v Austin*[27] in describing how extensive the difference must be before the transaction creates a penalty—a 'degree of disproportion' sufficient to point to oppressiveness.

The High Court noted that Mason and Wilson initially made the point that an agreed sum should only be 'characterised as a penalty if it is out of all proportion to damage likely to be suffered as a result of breach'.[28] The High Court noted that later their Honors' referred to proportionality as follows:

[Equity] and the common law have long maintained a supervisory jurisdiction, not to rewrite contracts imprudently made, but to relieve against provisions which are so unconscionable or oppressive that their nature is penal rather than compensatory. The test to be applied in drawing that distinction is one of degree and will depend on a number of circumstances, including:

1. the degree of disproportion between the stipulated sum and the loss likely to be suffered by the plaintiff, a factor relevant to the oppressiveness of the term to the defendant; and

2. the nature of the relationship between the contracting parties, a factor relevant to the unconscionability of the plaintiff's conduct in seeking to enforce them. The court should not, however, be too ready to find the requisite degree of disproportion, less that impugns upon the parties' freedom to settle for themselves the rights and liabilities following a breach of contract.[29]

The High Court considered that nothing in either passage supported the need to enquire into whether there is proportionality between the impugned provision and the legitimate commercial interests of the party relying on it.

Another reason for the court's rejection of the contended for doctrine of 'proportionality' between breach and supposed remedy is based upon the recognised freedom of parties not acting under a relevant disability, to agree upon the terms of their future relationships. Once again the court referred again to the comments of Mason and Wilson JJ in *AMEV–UDC Finance Ltd v Austin*:[30]

[T]here is much to be said for the view that the courts should return to ... allowing parties to a contract greater latitude in determining what their rights and liabilities will be, so that an agreed sum is only characterised as a penalty if it is out of all proportion to damage likely to be suffered as a result of breach.

The High Court concluded that the propounded penalty must be judged 'extravagant and unconscionable' in amount, and that it was not enough that it should be merely lacking in proportion and to hold otherwise would be a reversal of long standing authority.

State of Tasmania v Leighton Contractors Pty Ltd [2005] TASSC 133

The other case for consideration in a more conventional context of a construction dispute is that of the decision of the Full Court of the Supreme Court of Tasmania in *State of Tasmania v Leighton Contractors Pty Ltd*. [31]

In that case, the issue raised on appeal was whether a clause in a Deed of Agreement entered into by the parties was one providing for the payment of liquidated damages or constituted a penalty rendering it unenforceable.

Facts

In June 1999 the parties contracted for the design, construction and maintenance of road works requiring the re–alignment of a highway to by–pass a town. Delay and ensuing costs were the subject of complex proceedings between the parties, one of which concerned the status of clause 11 of a deed entered into by the parties, which provided for the payment of $8,000 per day in the event of non–completion of the construction by an identified date. Relying on the terms of the deed, the appellant had withheld from the respondent the sum of $8,000 per day from April to November 2001. At trial the respondent had argued that clause 11 was unenforceable as it constituted a penalty.

The overall cost of the project was $30 million which was to be paid by the Commonwealth of Australia to the appellant, either as a reimbursement or by way of progress payments.

Findings of primary judge

Clause 11.6 of the Deed provided:

11.6 Liquidated damages

(a) if the date of construction completion has not occurred by the date for construction completion, the contractor must pay liquidated damages at the rate of $8,000 for everyday after the date for construction completion until the date of construction completion or this deed is terminated, whichever is first.

(b) the amount referred to in clause 11.6(a) is a genuine pre–estimate of the principal's damages if the contractor does not achieve construction completion by the date for construction completion.

(c) The amount payable under this clause 11.6 will be a debt due from the contractor to the principal.'

The learned primary judge did not consider there to be any relevant imbalance in bargaining power between the parties and noted that the parties had conducted extensive negotiations and that detailed consideration had been given to the precise terms of the agreement.

The learned primary judge had regard to a calculation which provided a daily total of $7,985 and commented in the following terms at paragraph 238:

... the figures in that estimate are extremely high in themselves ... and the number of hours contemplated totally speculative in some cases. An allowance for two days per day every day for legal advice is even more speculative. I infer that ... calculations in respect of direct costs were inflated to produce a figure of $8,000 ...

And having considered authorities relevant to public utilities without anticipated direct loss of revenue, concluded:

in the present case, it does not appear that any estimation was made in respect of the principal's loss other than direct costs of supervising an over–run contract and it is my view that these costs are extravagant and exorbitant as they are totally disproportionate to the likely actual costs anticipated to be incurred. Further, the evidence is that the costs of the project were fully funded by the Commonwealth Government and the State has not been exposed to either its capital cost or the costs incurred after the Date for Construction Completion. In these circumstances I am of the view that the estimate of $8,000 for each calendar day of the delay was not a genuine pre–estimate of the likely damage to the State resultant upon the late opening of the by–pass and is unconscionable.

The appeal to the Full Court

In a joint judgement, the Full Court noted that the legal firm advising the State of Tasmania had addressed the question of a public utility and loss in cautious terms and that effect had been given to that advice in the formulation of the figure of $8,000 which was a reduction of an earlier suggested figure. The court also noted that the respondent did not raise its inclusion in the Deed as a matter of concern and that no amendment had been sought during the negotiation stage. Indeed the respondent had amended its pleading on the first day of trial to include the plea of a penalty and had shown no earlier concern. This lead the Full Court to consider an initial evidentiary issue being whether it was for the respondent to place before the court material to establish the status of the impugned clause or whether, on the evidence at large, the learned primary judge was permitted to make a finding adverse to the appellant.

On this matter the Full Court held that the respondent was entitled to rest its case on evidence obtained through discovery and cross examination and was not required to prove matters independently of those derived from its opponent's case.

The Full Court next considered grounds of appeal based upon proportionality and unconscionability.

The Full Court noted that the learned primary judge had used the terms 'extravagant', 'exorbitant', 'totally disproportionate', 'not a genuine pre–estimate' and 'unconscionable' to characterise CL 11 as a penalty. The Full Court noted that in doing so the learned primary judge had adopted the terminology used by the House of Lords in a long line of authorities and that the words were often used as an aggregate describing differing conceptual approaches to the test—the terms encapsulating the following propositions:

1. A comparison between the sum provided for in the event of a breach and the greatest loss which could conceivably be proven in the light of the total amount of the contract as a whole.

2. Comparison between the sum provided and the nature of the breach. If any breach activates the operation of a 'damages' term, irrespective of its import, then it might more readily be regarded as penalty ...

3. Equivalence of bargaining power at the time of agreement or whether one party was subject to unreasonable pressure in performance ...

4. The potential outcomes to which the clause was directed ...

5. The means, if any, used in the compilation of the sum provide for ...

6. The import of the contract provision for 'damage' to be considered at the time of the making of the contract, not as at the time of breach ...

The Full Court noted that in this case the learned primary judge correctly identified the relevant principals, and that the error claimed was one of application.

The Full Court considered in detail the approach adopted by the primary judge in reaching his decision that there had been no 'genuine pre–estimate' and that the figure of $8,000 was extravagant, exorbitant, disproportionate and unconscionable and found that conclusion to be an incorrect application of principle. The Full Court identified the question as whether, given the nature of the contract, its complexity, value and the bargaining strength of the parties, the amount of $8,000 was, in all the circumstances, a penalty as of the date of the agreement. The test was objective as of that date. The test was whether as at that date, allowing for potential incurred costs, public utility or loss of amenity, diversion of resources and future dealings with, or responses by, the Commonwealth, loss of capital or its equivalent, the sum was so disproportionate that it provided not for 'liquidated damages' but operated as a penalty which placed the then contracting party in terroram.

The Full Court noted that the contract itself provided for the expenditure of public money amounting to over $30 million and that delay in completion would impact on a public utility. In noting the quantification of that impact would be problematic, the Full Court regarded various calculations as no more than an attempt to provide a general basis for the assessment of an overall figure. The Full Court noted that the calculation involved a projection of costs for a period of two years into the future and that expensive delay might require expensive advice and involve the transfer of administrative or other resources from the State to accommodate difficulties caused by the delay in providing for the maintenance of existing infrastructure during that period.

The Full Court also considered a further basis of appeal, that the learned primary judge erred in wrongly finding that by reason that the principal was to have been reimbursed by the Commonwealth Government for all the costs of the project, the principal suffered no loss. The learned primary judge had concluded, as a part of his reasoning, that the terms of the Deed, CL 11, amounted to a penalty since it was an artificial construct, not a genuine pre–estimate of likely damage to the appellant because the 'costs of the project were fully funded by the Commonwealth'.

The Full Court said that even accepting that at the time of execution of the Deed the State was entitled to receive full and timely reimbursement, the fact remained that the State was required to be accountable for the expenditure of public money, irrespective of source. It went on to state [para 38]:

> *Public utility does not of itself disentitle the State or public authority from seeking, by way of damages, compensation for loss, the components of which are incalculable. Delay or breach of a particular term of agreement might result in loss or harm to public convenience such as transportation costs, provision of temporary or substitute infrastructure, continued maintenance of alternate services or increased administrative costs. The provision of public money does not change the character of a compensatory provision into one of penalty simply because the expenditure is to be paid by another public authority ... here the respondent was responsible to the appellant for loss occasioned by delay. That loss was calculated in advance and irrespective of whether another would reimburse for that loss, the responsibility remained as between the parties to the agreement.'*

INTERPRETATION RISK—CASE ANALYSES

One risk faced by all project participants is what is commonly referred to as 'interpretation risk', which commonly arises in consequence of imprecise drafting of key contractual provisions governing the relationship between the parties (most commonly in relation to time, payment, variations, latent conditions etc) and some times, arising through what has become known in the industry as 'battle of the forms' whereby there is not even agreement as to which set of contractual terms actually applies.

There are two recent cases concerning what written contract (if any) governed the dealings between the parties. Although *Monarch Building Systems Pty Ltd v Quinn Villages Pty Ltd*[32] can be considered in the context of risk in the supply of goods, the case is in many respects more apposite to the risks arising from a lack of clarity of the contract between the parties. Prior to considering Monarch however, we turn to consider a case from the Supreme Court of South Australia in a similar vein. That case is *Decor Ceilings Pty Ltd v Cox Constructions Pty Ltd; Cox Constructions Pty Ltd v Decor Ceilings Pty Ltd*. [33]

Decor Ceilings Pty Ltd v Cox Constructions Pty Ltd; Cox Constructions Pty Ltd v Decor Ceilings Pty Ltd No 2 [2005] SASC 483

Decor Ceilings Pty Ltd ('Decor') and Cox Constructions Pty Ltd ('Cox') were parties to a contract for the performance of building work at premises at Hindmarsh in South Australia. Cox was the main contractor and Decor was a subcontractor.

Although the case before the court concerned a number of matters, there was a dispute both before the arbitrator at first instance and before the court as to the terms of the contract between Cox and Decor. Both parties accepted that there was a contract between them, however Decor alleged that the contract was made on 31 March 1999 whereas Cox submitted that the agreement reached on 31 March 1999 was not a binding contract, or, if it was, it was overtaken by a later agreement in August 1999.

The court, after noting with surprise that in a contract of the value of the one before it, the question of what constituted the contract was an issue, relied upon the findings of fact made by the arbitrator.

Facts

Cox had lodged a tender for the project in September 1998 and received a letter of acceptance in December 1998, taking possession of the site in January 1999. Cox invited tenders for the subcontract work in September 1998. Decor lodged a tender in September 1998 for a fixed price and in March 1999, Cox wrote to Decor in the following terms:

> *Re: Training and Development Unit, Hindmarsh*
>
> *We confirm your appointment as the ceiling and wall lining subcontractor for the above project to carry out all works detailed herein for the sum of $689,000. Your Subcontract Agreement will be the companion contract (AS2545–1993) to the head contact [sic] for the works (AS2124–1992) with amendments as set out in the project specification...*

The judge noted that it was clear from the terms of this letter, that Cox was appointing Decor the ceiling and wall lining subcontractor for the project and that Decor was instructed to commence the works as previously agreed. At the same time, his Honour noted that it was

One risk faced by all project participants is what is commonly referred to as 'interpretation risk', which commonly arises in consequence of imprecise drafting of key contractual provisions ... and some times, arising through what has become known in the industry as 'battle of the forms' ...

clear that the parties envisaged that a more formal agreement would be prepared and executed. That followed from the reference in the letter dated March 1999 to AS2545–1993, which included Pt A and Pt B, and the nature of those documents, and the reference to the preparation of the formal instrument of agreement. His Honour noted that the arbitrator found that there was a contract between Cox and Decor as at 31 March 1999.

In July 1999, Decor wrote to Cox advising that 'we have not sighted a contract for the project as yet'.

At about this time, Cox had in fact prepared a package of contractual documents, including Pt A of AS2545–1993, with relevant information, and Pt B with deletions, amendments and conditions to the standard conditions. The package of contractual documents was said by Cox to have been sent to Decor by Cox on or about 8 July 1999 with a letter in the following terms:

> *Re: Training and development unit—Hindmarsh*
>
> *Please find enclosed your subcontract agreement (consisting of two originals) for the above project. The document must be signed, initialled on each page and returned to our office urgently for countersigning. Should you require a signed copy, return both contracts signed. An endorsed copy will be returned in due course…*

A representative of Decor initialled most, but not all, of the pages in the package of the contractual documents. Some items in Pt A and Pt B, and other items in the contractual documentation were changed. The package of contractual documents, as amended by Decor, was returned to Cox by Decor in August 1999. Decor also started work on site in August 1999.

In September 1999, Cox wrote to Decor, drawing attention to pages that had not been initialled (which Cox said it assumed was inadvertent), amendments made by Decor which it accepted, and three amendments made by Decor which Cox said that it did not accept.

The letter from Cox to Decor in September 1999 concluded with the following statement:

> *We have returned the agreement unendorsed, as we will not endorse an agreement that has been amended without prior agreement. Notwithstanding this, we maintain the agreement between our companies is binding as varied by this correspondence.*

Decor subsequently wrote to Cox later in September and said at the beginning of that letter:

> *We refer to your letter of 10/9/99 advising that an agreement has been reached between our companies, which is binding by your correspondence, which is not the case.*

There was no further correspondence between the parties which addressed the question of the execution by them of a formal agreement. Decor proceeded to carry out the works that were the subject of the tender.

The issue for determination—When did a contract come into existence?

Cox submitted that a contract came into existence in early August 1999 and consisted of the package of contractual documents, as amended by Decor, and returned to Cox in August 1999. The agreement was said to then be manifested by Decor commencing work on the site, and the fact that Cox, knowing that Decor had commenced work, failed to immediately object to the amendments proposed by Decor.

Decor submitted that Cox's case before the arbitrator was that the contract constituted the package of contractual documents prepared by Cox (i.e., the package of contractual documents without Decor's proposed amendments) that was accepted by Decor when it started work on the site in August 1999.

The judge noted a third possibility, which seemed to have been pleaded by Cox in one of its position papers, was that the contract was concluded in September 1999 and consisted of the package of contractual documents as amended by those amendments made by Decor and accepted by Cox in its letter of 10 September 1999.

Findings

The Supreme Court found that as at 31 March 1999, the parties had reached agreement upon terms of a contractual nature and they had also agreed that there would be a formal contract. It noted that whether, in that situation, there was a binding contract in March 1999 was a matter to be determined having regard to the intention of the parties objectively ascertained. The Supreme Court referred to the decision of the High Court in *Masters v Cameron*[34] in which three classes of case were identified, the first two of which amounted to a binding contract and the third which did not. The court in that case said (at 360):

> *Where parties who have been in negotiation reach agreement upon terms of a contractual nature and also agree that the matter of their negotiation shall be dealt with by a formal contract, the case may belong to any of three classes. It may be one in which the parties have reached finality in arranging all the terms of their bargain and intend to*

be immediately bound by the performance of those terms, but at the same time propose to have the terms restated in a form which will be fuller or more precise but not different in effect, or, secondly, it may be a case in which the parties have completely agreed upon all the terms of their bargain and intend no departure from or addition to that which their agreed terms express or imply, but nevertheless have made performance of one or more of the terms conditional upon the execution of a formal document. Or, thirdly, the case may be one in which the intention of the parties is not to make a concluded bargain at all, unless and until they execute a formal contract.

The court noted that there was said to be a fourth class of case in which there was a binding contract. In *Sinclair Scott and Co Ltd v Naughton* (1929) 43CLR 310, the High Court said (at 317):

The case is not one in which the parties were content to be bound immediately and exclusively by the terms which they had agreed upon whilst expecting to make a further contract in substitution for the first contract containing, by consent, additional terms.

The court referred to a case in which it was held that the agreement fell within the fourth class of case being, on appeal, *GR Securities Pty Ltd v Baulkham Hills Private Hospital Pty Ltd*.[35] In that case McHugh J A (with whom Kirby P and Glass J A agreed), said (at 634):

...even when a document recording the terms of the parties agreement specifically refers to the execution of a formal contract, the parties may be immediately bound. Upon the proper construction of a document, it may sufficiently appear that 'the parties were content to be bound immediately and exclusively by the terms which they had agreed upon whilst expecting to make a further contract in substitution for the first contract, containing, by consent, additional terms': Sinclair, Scott & Co Ltd v Naughton (at 317).

The court noted that the question of whether there was a binding contract in March 1999 was not an easy one, and that it was clear that there were a number of matters to be agreed as at March 1999. Nevertheless Besanko JJ reached the conclusion that the agreement of 31 March 1999 fell within the fourth class of case.

In reaching that conclusion, his Honour was influenced first, by the fact that the essential terms appeared to have been agreed at that time and that none of the matters identified by Cox in submissions as matters to be agreed seemed incapable of determination by reference to usual practice or the custom of the trade. His Honour agreed with Decor's submission that the price, scope of work, construction period and program, and standard conditions were agreed at that time. Secondly, his Honour noted that Cox itself saw matters as sufficiently agreed at that time to instruct Decor to commence works.

In concluding that there was a binding agreement at 31 March 1999, which included the original conditions, his Honour noted that it will be the amended conditions that would be relevant if there was a later, more formal or detailed agreement as alleged by Cox.

In this regard, his Honour observed that by the time Decor initialled the pages of the package of contractual documents in July or August 1999 there was a good deal of common ground between the parties and a level of detail agreed. However, the judge was of the view that the reasoning that lay behind the fourth class of case could not be applied to what occurred in July or August 1999, because by that stage what the parties had in mind was a final, complete and formal contract.

It was clear to his Honour that Cox did not accept Decor's amendments as it made clear in its letter of September 1999 and nor did Decor accept the position as asserted by Cox. Accordingly, it was quite clear that the parties did not reach agreement in July or August 1999 on a final, complete and formal contract.

In the circumstances, his Honour was not prepared to draw the inference from the fact that Decor commenced work on the site in August 1999 as constituting agreement by Decor to the package of contractual documents put forward by Cox, or that Cox's failure to object to the commencement of work constituted acceptance by Cox of the package of contractual documents as amended by Decor.

The consequence of the findings was that Cox lost the ability to incorporate its proposed terms into the contract. Moreover, Decor was entitled to proceed under a contract which had its schedule left blank, thus omitting matters such as an amount for liquidated damages and a date for completion.

Monarch Building Systems Pty Ltd v Quinn Villages Pty Ltd [2006] QCA 210

This case[36] was an appeal from a decision at first instance by the Chief Justice of the Supreme Court of Queensland, de Jersey CJ. In the decision at first instance,[37] the Chief Justice was asked to determine a preliminary issue of 'whether or not the parties reached a concluded contract, and if so, its terms' [para 6].

Monarch Building Systems Pty Ltd ('Monarch'), was the plaintiff, which manufactured and supplied steel products to the Building Industry. In the year 2000, Monarch supplied such products for incorporation into a home unit development at Mt Coolum to the defendant Quinn Villages Pty Ltd ('Quinn') who was the developer. Quinn's Project Manager was Global Construction Management Pty Ltd ('Global').

In proceedings subsequently issued in the Queensland Supreme Court Monarch sued Quinn, on the basis of a quantum meruit, for the unpaid value of goods supplied. The Chief Justice noted that Monarch's pleaded position was that between February and June 2000 it had unsuccessfully sought to negotiate with Quinn an agreement to cover the supply. On the other hand, Quinn had pleaded that a contract was in fact concluded in or about March 2000, for the design, fabrication, supply and delivery of the goods, a contract 'partly written, partly oral and partly implied' [para 2].

The facts of the matter as summarised from the judgment were as follows:

On 21 March 2000, Global advised Monarch that Quinn accepted Monarch as the 'successful trade contractor', and referred to 'formation of the trade contract'. Monarch responded the next day, saying that because it was supplying materials only, Global's proposed trade contract was inappropriate. Monarch included its standard supply terms, but Global, which acted throughout as agent of Quinn, insisted on its contract, which was in the TC/CM1 form, and sent Monarch a copy on 4 April 2000.

Monarch amended that contract in some respects, and sent the amended copy back to Global on 7 April 2000. The provision for the insertion of an amount per day for liquidated damages was left blank. On 14 April 2000, Global responded in detail to Monarch's amendments, 'clarifying our minimal [sic], [presumably meaning minimum] requirement as opposed to your inserted notations'.

Subsequent discussions between the parties ensued and in due course Global sent Monarch the latest amended version of the contract TC\CN1. Significantly, in that version representatives of Global had inserted amounts per day in respect of liquidated damages.

Having received the contract in that form, a representative of Monarch, while not deleting the clause in the contract in relation to liquidated damages, deleted the provision in the schedule and sent the further amended version, executed, back to Global with a covering letter saying 'the value of liquidated damages has never been part of the contract negotiations and has been assumed by Monarch as nil. Monarch does not accept this late inclusion'. Subsequently in June a representative of Global wrote to Monarch rejecting the changes. The letter said:

> *The vetting meetings of 13 January 2000 stated that an MBATCM/CM1 contract would be used for the contract. One of those conditions contained herein is liquidated damages. These clauses will not be excluded. That letter attached 'unblemished' copies of the relevant pages 'for your correct notarisation'.*

The minutes of the meeting referred to in that correspondence of 13 January 2000 which was attended by representatives of Monarch and Global read:

> *GCM advised MBS that if they were to be the successful trade contractor, then the form of contract they would be signed to with the client would be the Queensland Master Builders Association Trade Contract for Construction Management, known as TC/CM1. Accepted and Agreed by MBS.'*

On 5 June 2000, a representative of Monarch wrote to Global's director saying that Monarch was not prepared to accept the inclusion of liquidated damages, a matter which it referred to as an 'important' matter. The letter indicated an intention to take up the other outstanding contractual matters directly with Global's construction manager but that party's oral evidence was that these matters were not taken up with him.

The evidence of representatives of Global that they had made it clear to Monarch via its various representatives at all stages of negotiations 'that the standard trade contract had to be agreed and signed by the parties'. The evidence was that 40 Global at no stage conceded to Monarch 'that liquidated damages did not form part of the contract'.

His Honour went on to consider the parties subsequent communications, a number of which were consistent with the parties operating as if they were otherwise acting in accordance with and were bound to the form of TC/CM1 contract. Most tellingly in a letter to Global of 23 August 2000, Monarch dealt with the issue of the execution of the contract as follows:

> *You have also stated that Monarch Building Systems has not signed the contract. I trust that you are aware that I have signed contracts on behalf of Monarch Building Systems which were submitted to your project manager... Your version of the contract had been amended to align with our negotiated agreement, as advised to you in the letter covering the signed*

contract. It is therefore your company which has failed to sign a contract on behalf of your client…

Conversely, in that same month, Global expressly reserved its right to claim damages under clause 2(a) (the relevant liquidated damages clause).

His Honour noted a glaring inconsistency between the position taken by Quinn in its pleading (which included a counter–claim for $504,814.00 liquidated damages) and the submission of Quinn's counsel which was that the conduct of the parties from early 2000 to at least September 2000 was consistent with their assumption that they were contractually bound to an agreement 'Shorn of liquidated damages provision'. Counsel for the plaintiff, on the other hand, had pointed to the parties fundamental commitment to an executed contract in the form of TC/CM1, which would have included a liquidated damages clause, confirmed at the 'vetting meeting' on 13 January 2000: because that was never executed, it was submitted that no binding contract arose and Monarch's entitlement must fall to be assessed on the basis of a quantum meruit.

The Chief Justice considered the law in this area to be clear and discussed comprehensively in a number of relatively recent decisions. de Jersey J stated:

In a case like this where there is no contractual document executed by both parties, the question is whether they nevertheless intended to be bound to the extent that they had reached agreement: 'whether viewed as a whole and objectively from the point of view of reasonable persons on both sides, the dealings show a concluded bargain' (Meates v Attorney General [1983] NZLR 308 377 per Cooke J). It is not essential that one be able to identify a discrete offer and a discrete acceptance, or the precise moment when a contract came into existence (Integrated Computer Services Pty Ltd v Digital Equipment Corp (Aust) Pty Ltd [1988] 5BPR11, 110, 11, 117–8 per McHugh JA). The parties may agree to be bound now, 'while deferring [even] important matters to be agreed later' (Pagman Spa v Feed Products Pty Ltd [1987] to Lloyd's Rep 601, 619). In determining the intention of the parties in a case like this, that is, whether or not to contract, relevant circumstances may include prior negotiations and subsequent conduct (African Minerals Ltd v Panpalladim Ltd [2003] NSWSC 268).

In answer to the defendant's contention that a definable consensus between the parties may be inferred from their subsequent conduct, the Chief Justice stated:

What then is to be drawn from the parties' having proceeded on the apparent assumption or view that they were contractually bound? The eventual question is whether objectively, one infers from all relevant circumstances their intention to be bound, and to be bound to a particular contract. That the parties considered themselves contractually bound, it does not resolve this case. That is because one cannot answer the next question: To what particular contract were they bound? Once one acknowledges the apparent significance to the parties of the liquidated damages provision, their persistent inability to resolve their differences over that position, and the effective role of that disagreement in forestalling full execution of the contract form, it is not possible to conclude that the parties bound themselves to a contract 'Shorn of the liquidated damages provision.

The Chief Justice noted that the most likely inference was that Global was assuming a contract including the liquidated damages schedule amounts, whereas Monarch was assuming a contract which did not specify those amounts. This led the Chief Justice to conclude that no consensus could be inferred as to the content in one important respect of the assumed agreement, and that liquidated damages question remained alive, at all relevant times, and held up the execution of the contract which itself was 'plainly of importance to the parties' [para 57]. The Chief Justice additionally concluded that there was no reasonable basis for an inference that the parties determined to proceed on the basis of having reached agreement on all other matters, those would in the interim combine to constitute a binding contractual.

The Chief Justice accordingly concluded that any entitlement in Monarch fell to be determined on the basis of a quantum meruit.

The decision on appeal

The declaration made by the Chief Justice 'that there was not a concluded contract between the parties as alleged by the defendant' was appealed to the Queensland Court of Appeal comprising Williams JA, Jerrard JJA and Mullins J. The leading judgment was delivered by Williams JA who noted that the issue that the Chief Justice had been asked to determine was inconsistent with the conduct of the appellant up that point in time in asserting that the contract contained an express clause providing for liquidated damages. In noting that the preliminary issued ordered to be separately determined, could have been simply resolved and that there was no contract as alleged in the relevant paragraphs of the third amended defence, set off and counter claim, Williams JA noted that it was necessary for the Court of Appeal to consider the broader question raised by counsel for the appellant at the outset of the hearing before the Chief Justice, namely whether it could be said that there was a contract, entered into in March 2000, in the TC/CM1–1999 form, but without a liquidated damages provision.

In considering the issue, Williams JA had regard to the law as stated by Bingham J at first instance in *Pagnan SpA v Feed Products*[38] where he said:

> *Where the parties have not reached agreement on terms which they regard as essential to a binding agreement, it naturally follows that there can be no binding agreement until they do agree on those terms: See Rossiter v Miller [1878] 3 App Cas 1124 at 1151 per Lord Lackburn. But just as it is open to parties by their words and conduct to make clear that they do not intend to be bound until certain terms are agreed, even if those terms (objectively viewed) are of relatively minor significance, the converse is also true. The parties may, by their words and conduct, make it clear that they do intend to be bound, even though there are other terms yet to be agreed, even terms which may often or usually be agreed before a binding contract is made: See Love & Stewart Ltd v Instone & Co Ltd [1917] 33TLR 475 per Lord Loreburn LC at P476.*

Williams JA also noted an observation to similar effect by Kitto J (with the concurrence of other members of the High Court) in *Thorby v Goldberg*:[39]

> *It is only where future agreement is required in order that the agreed provisions and those to be agreed shall operate together as one contract that the agreed provisions cannot be treated as themselves constituting a contract'. Or...'Put in another way, if a term, regarded by the parties as essential to their being a binding agreement, is not agreed upon, then other terms agreed upon in the course of the negotiations will not constitute a binding contract between the parties.*

Applying these principles, Williams JA considered that the judgment at first instance was clearly correct in concluding that there was no contract between the parties as contended for by the appellant in the Third Amended Defence, Set Off and Counter Claim and that further, the judgment at first instance was also correct in concluding that there was no contract as contended for in oral argument, namely a contract in the TC/CM1–1999 form without the liquidated damages provisions.

In arriving at that conclusion Williams JA noted that in the present case any objective onlooker would not conclude that there was an agreement between the parties evidenced by the TC/CM1–1999 form of contract (either in its original or amended form) because it was clear that the appellant regarded the provisions as to liquidated damages as essential and the respondent was not willing to accept those provisions as terms of any agreement with the appellant.

In arriving at the same conclusion Jerrard JA concluded that there was no agreement on what each party clearly considered to be a significant term and that further both parties considered the execution of the contract was an important step which would then bind that party to its terms. Mullins J agreed with the reasoning of Williams JA and it followed that the appeal was dismissed.

Observations in relation to the *Monarch* decisions

Fundamentally the decisions highlight the importance of parties who seek to rely upon provisions in a written contract to ensure that the terms of that contract have been agreed and that the contract has been executed by both the parties.

There are in the writer's view however, a number of more subtle matters arising from the decisions. In the decision at first instance, the Chief Justice stated that 'The issue for separate determination is therefore whether or not the parties reached a concluded contract and if so, its terms' [para 6].

The Chief Justice in making a declaration that there was 'not a concluded contract between the parties as alleged by the defendant' opined [at para 58] that 'any entitlement in Monarch falls to be determined on the basis of a quantum meruit'.

On appeal however, Williams JA noted [at para 44]:

> *Neither at first instance nor on the hearing of the appeal did counsel for the appellant contend that there was some contract between the parties other than one based on the TC/CM1–1999 form. Whether the conduct of the parties could have resulted in a contract in some other form being implied was not argued. The general consensus appeared to be that if there was not a contract in the form contended for by the appellant, then the rights of the parties fell to be determined upon a quantum meruit.*

Williams JA however went on to state [at para 51]:

> *There was obviously some arrangement between the parties relating to the supply of*

> *materials by the respondent for the appellant's project. As already noted the court was not asked to determine whether the evidence established some other contract than that contended for by the appellant; the matter was put to the court on the basis that if there was no contract as contended for by the appellant, then the respondent's claim was to be resolved on a quantum meruit basis.*

Accordingly, the case may not be authority for the proposition that in the absence of either a signed written agreement or at least agreement as to terms in relation to liquidated damages, the only basis for payment by the supplier of materials to a project is on a quantum meruit basis. The 'arrangement' alluded to by Williams JA was no doubt one for the supply of materials for an overall agreed price to the project, and there would appear to be no reason why a contract with basic terms supported by the parties conduct could not have been established if one had been contended for.

Nor is the case authority for the proposition that in the absence of an executed document, a contract in terms of form TC/CM1–1999 could not have been the contract governing the relationship between the parties. As the Chief Justice noted [at para 53]:

> *Now it may be that if all matters were agreed, the lack of execution would nevertheless not necessarily have meant there was no binding contract... but the reality is that because of the position in relation to liquidated damages, all relevant issues were not agreed.*

While the decision was undoubtedly correct that there could be no contract in existence said to contain the operative clause in relation to liquidated damages, the writer would respectfully question whether it was truly necessary that the contract be 'shorn of the liquidated damages provision' before it could ever be said that the parties were otherwise bound to the terms contained in the TC/CM1–1999 form.

As the Chief Justice noted [at para 45] in early June 2000, the parties' clear mutual intention had been to execute a contract in the form TC/CM1 and the reason or substantial reason that had not occurred was a disagreement over the 'specification of amounts' in respect of liquidated damages liability.

In the writer's view, this is important as it suggests that the disagreement between the parties related fundamentally not to the inclusion of Clause 2(a) of the 'Conditions of Contract' which formed part of the TC/CM1 standard form, but rather the amount (if any) to be allowed by way of liquidated damages by reference to the sum stated in the Schedule.

In light of the Chief Justice's comment [at para 53] that the lack of execution would nevertheless not necessarily have meant there was no binding contract, and the fact that the minutes of the meeting of 13 January 2000 noted that Monarch was advised that if it were the successful contractor, then the form of contract that they would be signed to would be TC/CM1 (which was said to have been accepted and agreed), then a contract in those terms incorporating price, scope of works etc could with respect, arguably have come into formation upon the award of the supply order to Monarch.

As the provision in relation to liquidated damages could remain in the contract and operate equally as effectively with a notation in the schedule of 'Nil' as with a monetary amount (per day or week of delay), it may not in fact have been necessary for it to have been contended for the liquidated damages provision to be 'shorn' in order for the standard form of contract to have had some contractual force between the parties.

The case does not however appear to have been approached on that basis.

It is also worth noting that while the liquidated damages 'question' was said to be 'a matter plainly of importance to the parties' [para 57 of the judgement of de Jersey CJ] the only difference was in reality in relation to the liquidated damages schedule amounts. The failure to insert an amount in the schedule of the contract is not necessarily substantive in the sense of impacting on the parties right to include the liquidated damages provision in the body of the contract or otherwise claim damages (albeit potentially of an unliquidated amount) in the event of delay or other breach of the contract.

While the decision both at first instance and on appeal was undoubtedly correct, based upon the matters upon which the court was asked to make a determination, it seems unlikely that the case stands as authority for the proposition that recovery on the basis of quantum meruit is the only avenue open to a party in these circumstances. Rather the matter was put to the court on the basis that if there was no contract as contended for by the appellant, then the respondent's claim was to be resolved on a quantum meruit basis.

LOOKING AT WHERE RISK ALLOCATION IS HEADING

There are a number of developments impacting, or likely to impact upon approaches to risk allocation and risk management going forward.

There has been a rapid convergence between insurance and financial markets in recent years. In the same way that the reinsurance market has been developing the concept of catastrophe bonds, financial engineers should ensure new and innovative ways to lay off risk via accessing the pool of worldwide capital now looking for a home.

The emergence of the financial engineers themselves and their heavy involvement in major infrastructure consortia may increasingly see the risk/reward profile determined less by an assessment of traditional construction risk, and more so by the ability of the project to service the facility, meet the requisite financial return, and the management of completion risk.

There is also the somewhat disturbing emergence of potential uncertainty created by such things as proportionate liability and security of payment legislation, which may have the effect of cutting across carefully negotiated allocation of risk and accordingly may threaten the involvement of parties, once again principally financiers, in projects. While the risk of this should not be overstated, nor should it be dismissed. The emergence of the tort of negligence—imposing liability in respect of pure economic loss in the construction arena—sometimes seemingly at odds with the carefully balanced risk allocation negotiated by the parties, and in particular the emergence of s51AC & s52 of the *Trade Practices Act 1974* (Cth), have already created unwelcome uncertainty and can be a real concern, particularly to overseas interests who may reconsider their involvement if they feel that the consequence of a risk event can be determined after the event by a third party tribunal and without due regard to the negotiated risk allocation[40].

The trend away from some of the more traditional modes of project delivery has challenged the approaches of some parties who have historically sought to transfer risk by the use of indemnities and insurance. Clearly these are inappropriate in project alliance agreements for example, where the principal will often accept design risk and the risk of associated cost overruns and may be met with reluctance on behalf of insurers to cover such risk in circumstances where it is ultimately within the control of others.

Similarly the move towards partnering and relationship contracting and the uncertain legal status of a partnering charter (and potential obligations arising there from—good faith, etc) while militating against some traditional risks, may see new ones emerge.

The so called ‘insurance crisis’, coupled with the shrinking availability of insurances in the immediate aftermath of 9/11, have certainly led to astute commercial organisations assuming far greater responsibility internally for the management of risk and this can be observed in the growing legal and risk teams of our major contractors and engineers. The use by some of our very large corporations of ‘captives’ and the very significant deductibles being borne by most contracting organisations has seen a renewed focus on risk assessment and management at an early stage of projects, although empirical data as to the effectiveness of these processes is not yet readily available.

It is also worthy to note that since 2000, Australia has seen the emergence of PFI initiatives in the form of PPP procurement by governments. Given that the justification now given for such proposals is value for money by the achievement of optimal allocation of risk, an extensive risk assessment is called for, firstly to determine the Public Sector Comparator (PSC) and then to accurately assess the proposals being put forth by interested parties. These PPP participants will necessarily have to consider risk right through from conception to operation and termination.

While the overriding principle in PPP procurement is that risks should reside with the party best able to manage them, in reality it has tended to be only demand related risks which are retained by the public sector. The Partnership’s Victoria policy on PPPs contains a useful guide to risk allocation in relation to PFI projects, consideration of which is beyond the scope of this article.

Suffice to say, that with operating periods of between 25–45 years, a variety of risks can arise that may not do so in traditional contracts of lesser duration. No doubt the Ontario government (in its well publicised dispute with the owners of the private tollway 407) may wish they had heeded John Quiggin’s suggestion of the inclusion of appropriately designed put and call options, as a way to guard against unforseen risks emerging during the long period of the PPPs concession.[41]

As a final observation, it remains the case that no amount of risk assessment, management and treatment will guarantee that issues with serious financial and other consequences will not arise during the course of what is a dynamic and inherently risky enterprise. Accordingly, the attention increasingly being afforded to the careful drafting of dispute resolution clauses and innovative modes of dispute determination within the project documentation itself is to be welcomed.

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