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Dealing with '*Unknown Unknowns*' in construction contracts

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'*Unknown Unknowns*' are not simply a Donald Rumsfeld double negative; but can now also be considered a genuine area of claims in relation to construction contracts.

We are all familiar with the concept of '*Known Unknowns*', the classic being latent conditions. These are known areas of risk where the specific risk itself is unknown, but the possibility has been addressed by implementing processes under the contract for managing the response and making claims where the risk materialises.

'*Unknown Unknowns*' are a broader class that are increasingly becoming an issue both for contractors and for principals or head contractors. We are currently seeing '*Unknown Unknowns*' of two clear types creeping into construction contracts. The first is the requirement for contractors to accept wholesale liabilities under upstream contracts entered into by the head contractor. The second is broad, general acceptance of liability clauses designed to capture and transfer all liability to the contractor irrespective of cause.

Upstream obligations

It is increasingly common, particularly in large scale infrastructure projects, to see clauses that have the effect of making the contractor liable where they cause the head contractor to be in breach of the head contractor's upstream contracts. For example:

> '*The contractor warrants that it will not cause the head contractor to be in breach of any obligations under the head contract.*'

The difficulty with this scenario is that commonly, not only has the contractor not seen the full head contract, but the contractor also has no visibility or control as to how those head contract obligations are being managed. Further, the contractor is generally only one of a number of subordinate contractors to the head contractor and therefore generally has only a proportionate impact on how the head contractor manages its obligations.

A further difficulty is that sometimes it is not a single head contract but a series of inter-related documents. This is particularly common with major government infrastructure projects where there is generally a government department or authority, often a government owned corporation (or former corporation, particularly with respect to rail) and other broader state or federal government or regulatory bodies. Often there are three or four inter-related documents under which the head contractor is obliged to deliver the project.

Unfortunately for contractors, even in circumstances where the contractor has not seen the relevant upstream documents, there is case authority that indicates that if the contractor agrees to accept obligations with respect to the upstream contracts, then the contractor is likely to be bound.

In *Surfstone v Morgan Consulting Engineers* [2017] Qd R 66, a dispute arose as to whether a contract could incorporate an engineering standard by reference. The engineering standard included a provision releasing a party from all liability a year after completion. The party seeking to exclude the term argued that it should not be incorporated because the term had not been brought to its attention. Justice Morrison disagreed and held that where the provisions in the separate document are not unusual in nature or particularly onerous so as to be unusual, they may be incorporated by reference even if they are not specifically drawn to the attention of the party disputing their inclusion to the contract.

His Honour distinguished the scenario in *Surfstone* from the long line of authority regarding exclusion clauses in separate documents referred to as the '*ticket cases*'.[1] It can be concluded from the '*ticket cases*' that limitation of liability clauses in separate unsigned documents will not form part of the agreement if the terms are not brought to the attention of the party receiving the ticket and the terms are unusually onerous, or the parties are not given a reasonable period of time to consider the separate document. Justice Morrison found that a point of difference in *Surfstone* was the longstanding use of the terms in the structural and civil engineering industry, which was an important factor in His Honour's conclusion that the terms were not so unusual or onerous as to require them to be brought to the attention of the party against whom they were relied on.

The decision in *Surfstone* makes it unwise to presume that clauses in documents incorporated by reference to a contract will not be upheld simply on the basis that they are unseen or onerous. Due diligence must always be undertaken on documents incorporated by reference to ensure there are no nasty surprises.

A related problem can arise where documents incorporated by reference determine substantive obligations and time periods under the contract between the parties. It is common practice for contracts to make the exercise of a right conditional on the occurrence of some other event. Often this event may be linked to an occurrence or act required by an upstream contract. For instance, a contractor's defects liability period may be tied to the expiry of a period determined pursuant to the head contract between the head contractor and the principal.

This precise scenario was considered by the court in *Wright v Lend Lease Building Pty Ltd* [2014] NSWCA 46. The relevant clause in dispute in *Wright* provided for the release of retention monies upon the expiry of the '*Defects Liability Period*', which was defined under the subcontract to commence on the Date of Substantial Completion and expire '*24 months after the Date of Final Acceptance (as defined under the Head Contract)*'. The subcontractor submitted that the literal meaning of '*Defects Liability Period*' under the subcontract was absurd because:

(a) the '*Defects Liability Period*' may be an indefinite period if Final Acceptance is never reached under the Head Contract; and

(b) it could not be the commercial purpose of the '*Defects Liability Period*' to require the subcontractor to wait for the release of security until all other subcontractors (and the contractor) had satisfied their respective obligations so as to achieve Final Acceptance under the Head Contract.

President Beazley, with Justice MacFarlane agreeing, rejected the submissions of the subcontractor in finding that the meaning of the relevant clause and '*Defects Liability Period*' was not absurd, even though the expiry of the Defects Liability would not be possible to determine until certain events under the Head Contract had transpired. Parties to a contract have the freedom to agree to a date for the end of an obligation that is set in reference to a future event so long as the date is sufficiently certain, even if that date is not known at the time of entering into the contract. His Honour found that the commercial purpose of holding the retention monies until the end of the Head Contract was clear – the contractor did not wish to be required to release retention amounts under subcontracts until its obligations under the Head Contract had expired.[2]

The difficulties here are obvious - how does a contractor manage broad scale obligations that are not all within its control and that it does not have full knowledge of? The penalties of course can be disproportionate to the value of the relevant contracted work.

What is the solution?

Rather than simply adding a clause in to a contract that makes a contractor generally liable for all head contract obligations, the best solution is to clearly examine these obligations and to draft appropriate pass through or flow down provisions in the contracts subordinate to the head contract. Although this involves more work, it leads to better outcomes for both parties. From the contractor's perspective, the contractor knows exactly what it is required to do in relation to the head contract. This includes not only technical compliance issues but also administrative issues under the contract. For example, if claims are made under the contract within the timeframes required under the head contract, then it allows the head contractor to manage a back to back claim upstream and ensure that the contractor receives more timely outcomes or payments.

Why is it better for the head contractor?

Although the pass through of blanket liabilities to a contractor is simple and may seem like a way to fully cover all obligations, the reality is that if a contractor does not actually know what it is obliged to do to ensure the head contractor is not in breach of its obligations upstream, then the contractor may not be able to adequately comply. Ultimately, what a head contractor is striving for is the efficient management of its range of contractors to ensure that the head contractor meets its obligations. If each contractor clearly knows what its obligations are

and its place in the proceedings, then this is much more likely to occur.

For more complex projects, another sensible option is an interfacing arrangement between the different contractors. This can be by way of a formal interface deed which sets clear lines of communication and obligations, or can be by less formal processes whereby the contractors are directly involved in joint consultation and represented at site or development management meetings. If the contractors are managed and coordinated then this can reduce claims and delays to the head contractor.

Blanket liability provisions

This type of clause varies in scope and impact. What they generally have in common though is an acceptance of broad risks, many of which are not within the control or knowledge of the contractor. Two examples that we have seen with more frequency in recent times are broad site risk clauses which incorporate words in the nature of '*the contractor warrants the suitability of the site for the Works*'. The second type is a broader catch all obligation incorporating words in the nature of '*unless otherwise specified, the contractor accepts all risks in carrying out the work under the contract*'.

The first point to make here is that the ability to accept such clauses will very much depend on whether or not it is a construct only or a design and construct contract. Where it is a construct only, then such broad obligations should usually be resisted or heavily qualified by contractors. The issues around development, business case assessment and design of the works are not within the scope of the works undertaken by the contractor. The contractor generally will only be warranting the constructability of the works and not whether they are appropriate, fit for purpose or other general obligations of that nature.

As noted above, while it is unrealistic for contractors to accept these blanket types of liabilities under construct only contracts, there is an expectation that contractors under design and construct contracts will accept a significant portion of the uncertainties due to the contractor controlling or managing the design. However, even with design and construct contracts sensible limits should be negotiated with respect to unknown liabilities.

With respect to site suitability, it is not as simple as considering latent conditions. There are a large number of other variables that are often not assessed or otherwise considered by the contractor and with respect to which the contractor should be very circumspect in accepting liability. For example, surveys of the site will usually be conducted by another party so the risks associated with the site's boundaries are not within the Contractors control. Similarly, unless the contractor is involved from the outset, it will have little control over the interactions with neighbours, who if disgruntled, can cause significant delay and cost with respect to access issues.

Broad undertakings by contractors as to the appropriateness, suitability or fitness for purpose of a site can be very dangerous. Contractors will generally not have undertaken assessments in this regard in relation to a site and are unlikely to be able to evaluate issues such as marketing, saleability or future uses of the site in the long and potentially even in the short term.

Contractors should also pause before accepting '*all*' liability clauses in an agreement. These clauses can have severe ramifications for the contractor's ability to make claims for losses outside of the contractor's control. A contractor who accepts all risks for the work carried out may find itself in a position where it bears the full liability for costs and losses even where the fault for the costs and losses lies with another party. A common example is where there are other contractors or even potential customers of the principal on site who may cause damage. Although, the contractor may have common law or tortious rights to recover against those other parties, at first instance the contractor is fully liable to the principal/head contractor, who may have access to set-off or security for immediate recovery against the contractor under the contract terms, whereas the contractor will need to sue third parties and take its chance on recovering contribution.

In *MacMahon Mining Services v Cobar Management*, Justice McDougall considered a clause that excluded liability for consequential loss and observed that that the parties were entitled to construct a '*careful bargain in which they provided for the way in which liabilities each other might have to the other would be limited or regulated*'.[3]

This decision reflects the general approach in Australia where courts have generally upheld clauses that have wide exclusions or limitations on liability provided the terms of the clause can be applied literally without creating absurdity and without defeating the main object of the contract.[4] The court will not protect you from a clause that you knowingly agreed to just because it results in a bad outcome for you.

Why do we have such blanket provisions?

There are a number of reasons but in commercial projects it is generally driven by financial certainty. The overwhelming majority of contracts in Australia are fixed price or guaranteed maximum price contracts. This is because the principal will generally have a relatively fixed level of financing with minimal contingency and therefore aims to shift liability for any additional cost or risk to contractors. While this is understandable from a commercial perspective, it can be unrealistic from a risk management point of view.

Another financially related reason, and this particularly relates to government funded projects, is the unwillingness of governments at every level to spend beyond an allocated budget. There are often provisions in government contracts that require the head contractor to specifically shift risk down through its contractor and subcontractors so that this cannot come back to the government funding entity.

There is a further significant potential impact of such broad liability clauses. For most contractors the element of risk under contracts is heavily insured. However, where there are broad unknown and uncapped liabilities, then this may impact on the level of insurance coverage

available. All policies will have limitations and specific exclusions. If by accepting certain general obligations, contractors voluntarily and contractually accept risks that have been generally excluded under policies of insurance, then they may limit their insurance coverage. It is strongly recommended that any contractor who is providing general acceptance of risk should clarify with its insurer in advance to determine whether or not they are insurable risks or whether additional insurance coverage is necessary.

From the principal/head contractor's perspective, enforcing blanket provisions may also be problematic. If the obligations are too onerous and the contractor does not have the capacity or the finances (or the adequate insurance) and the contractor is unable to perform or otherwise meet its obligations, then the principal/head contractor will be deprived of the benefit of the blanket provisions. Finding that a contractor is on the brink of insolvency or otherwise has to be replaced, will cause delay and costs that may not be recoverable. From a principal/head contractor's perspective, managing a risk through sensible liability which can be recovered is better than having no recovery at all against an insolvent contractor or a contractor without genuine capacity to rectify the breach.

How can exposure be limited?

The simplest way is of course for contractors to avoid accepting general blanket obligations. If that is not possible, then at a minimum there should be a carve-out for contribution by the principal/head contractor and their consultants, suppliers and other contractors/subcontractors.

In design and construct contracts, the contractor should strive to only accept liability for consultants, suppliers or subcontractors who have been novated to the contractor – so that the contractor has rights directly against those parties. Of course the contractor will also need to ensure that the novation does include liability on the part of the consultants etc. for appropriate risks. If the principal has engaged a consultant on a basis that the consultant accepts minimal risk and that is then novated to the contractor, that does not give a great deal of benefit or protection to the contractor. Either the contractor will need to renegotiate risk with the novated party or minimise the liability that the contractor accepts from the principal.

The contractor will also need to ensure that any novated parties are adequately insured, or covered under the contractor's policies of insurance with appropriate obligations for the novated party to pay any excess or deductible to claim under that policy.

Another fundamental risk protection mechanism for contractors is to agree specific caps on liability. These can be particular monetary caps, a series of sub-caps on different elements of liability or they can be caps that are subject to insurance recovery. This provides for protection for the principal/head contractor with respect to the relevant risk, but limits the overall liability of the contractor so that they are not necessarily accepting totally uncapped liability levels for liabilities the scope of which is unknown and over which they do not necessarily have control.

There will always be unknowns in construction contracts but with some sensible drafting and agreed approaches on risk management and liability, both contractors and principals can ensure that there are processes in place to deal with those unknowns so that both parties are adequately protected.

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[1] See e.g. *Baltic Shipping Co v Dillon* (1991) 22 NSWLR 1; *Oceanic Sun Line Special Shipping Company Inc v Fay* (1988) 165 CLR 197.

[2] It should be noted that after the High Court's ruling in *Maxcon Constructions Pty Ltd v Vadasz* [2018] HCA 4, any provision that ties the release of retention monies to the completion of the head contract is likely to be deemed a '*pay when paid*' provision and invalidated by the relevant Security of Payment legislation. However, the larger point in Wright stands – dates tied to events under separate contracts will be valid provided they are sufficiently certain and reflect the commercial purpose of the agreement.

[3] [2014] NSWSC 502, [30].

[4] The unanimous joint judgment in *Darlington Futures Ltd v Delco Australia Pty Ltd* [1986] 161 CLR 500 cited the judgment of Justice Walsh in *H & E Van Der Sterren v Cibernetics* (1970) 44 ALJR 157 with approval on this point.

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