Russell McVeagh

Breaking Ground

Russell McVeagh
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Industry spotlight

No appetite for risk: What happens if your construction project is uninsurable?

It is becoming increasingly difficult to secure insurance for construction projects in parts of the Pacific Islands. The entire suite of insurance products, from contract works insurance to directors' and officers' indemnity cover, appear to be affected.

Blame can be attributed to both new and existing factors. Internationally, a number of large-scale construction projects have encountered difficulties in recent years.

By way of example, the collapse of a diversion tunnel system in Colombia's Ituango hydroelectric project may result in losses of up to USD$4 billion: the largest insurance loss in civil infrastructure construction history.[1] Anecdotally, we are also aware of construction projects in Australia which have resulted in losses of up to AUD$900 million, while, closer to home, SkyCity has reported that claims associated with the 2019 Convention Centre fire are likely to reach more than NZD$300 million.[2]

Such losses have contributed to a reluctance on the part of many insurers to become involved in the more complex construction projects. Projects in the Pacific Islands are amongst those that newly cautious insurers are choosing to forego, with pre-existing issues relating to the inaccessibility of the region, and its propensity for harsh weather conditions, significantly increasing the risk.

Repercussions for the construction industry

While projects can still proceed in the absence of insurance, doing so, particularly in such a complex environment, is not for the faint hearted.

Large-scale construction projects in the Pacific Islands frequently use NZS 3910:2013 or NZS 3916:2013 forms as the head contract. These set out the minimum insurances which should be held, including construction (i.e. contract works), plant, public liability, and professional indemnity insurances. The NZS terms are clear that, to the extent a party has failed to effect insurance in accordance with its contractual obligations, that party will be liable for the full amount of any uninsured loss.[3]

Before tendering

The scarcity of insurance products in the Pacific Islands is something parties should now carefully consider prior to tendering for a project in the region. At that stage, there are three main options available:

- The parties can take all reasonable steps to ensure that the necessary insurance products are in fact available. It is not safe to assume that previous availability (or previous pricing) will still apply. If only some insurance products are available, or the price is high, the parties may want to consider tailoring the insurance clauses in their contract to accommodate this.
- If there is time, parties can agree to make the contract explicitly subject to the ability to secure insurance, enabling parties to proceed with finalising all other details of the contract, but without being bound to it should the anticipated insurance arrangements fall through.
- One or both parties bear the risk. Commercially, this is more likely to be the principal, on the basis that they chose to build on the site.

But what happens if the parties have not taken the above precautions, and it transpires, after entry into the contract, that the relevant insurance is unavailable, or available only at great expense?

Frustration of contract

In such a situation, the parties may consider contractual frustration. This is a remedy provided by clause 14.1 of the NZS contracts, and which is also provided for by the provisions of the Contract and Commercial Law Act 2017 (CCLA).

Clause 14.1 provides that, where a contract has become "impossible of performance or otherwise frustrated", the contract will be discharged.[4] If frustration is established, clause 14.1.2 makes provision for the appropriate allocation of costs between the parties. If the parties disagree whether the contract has in fact been frustrated, the usual dispute resolution processes under the contract will apply.

So, when might an inability to secure insurance frustrate a contract? The starting point is that, if the contract already allocates the risk of a particular event occurring, and the event does in fact occur, frustration will not be available.[5] Clause 8.1.4(c) of the NZS contracts explicitly provides for the risk of either party being unable to obtain insurances under the contract. This means that, in the absence of a modification to this clause, unavailable insurance is unlikely to amount to frustration.

Where the contract does not provide for such risks, and frustration is therefore still available, the following key principles will apply:

- To argue frustration, a supervening event must have occurred after the formation of the contract, through no fault of either party.[6]
- The event must either have made the contract impossible to perform, or so significantly changed the parties' contractual rights or obligations that it would be unjust to hold them to it.[7]
- If the event has merely increased the expense or onerousness of performing the contract, it will not amount to frustration.[8]
- Reliance cannot be placed on a "self-induced" frustration – that is, a failure to make the necessary inquiries prior to entering into the contract. [9]

In general terms, whether the unavailability of insurance is capable of frustrating a contract is therefore likely to come down to a matter of timing, and knowledge. Did the parties know about the risk when they entered into the contract? And if they didn't, should they have? It is also likely to require insurance to be unavailable – merely increasing the cost is unlikely to be enough.

Contractual mistake

Where frustration does not apply, another argument may be available: contractual mistake.[10] While frustration can only capture issues that have arisen after entry into the contract, contractual mistake deals with issues which were present before entry into the contract (or issues with the contract itself).

This applies where parties are influenced to enter into a contract by a mistake – either as to the relevant facts, or relevant law. It might apply where both parties make the same mistake, or where one party makes that mistake, and the other party is aware but does not correct them. For example, if both parties to a contract had assumed that it was to be conditional on the availability of the usual insurance coverage, or had assumed that all necessary insurances would in fact be available, and that mistaken understanding influenced their decision to enter into the contract, the doctrine of mistake might apply.

Conclusion

The scarcity of insurance products in the Pacific Islands region is a problem to which the NZS contracts will not easily respond. Should the problem arise only after the project is on foot, the availability of appropriate remedies will be extremely fact specific. It is far better to address the issue before the contract is finalised.

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Endnotes

1 https://www.tunneltalk.com/Colombia-08Oct2020-Collapse-of-the-Ituango-hydropower-project-collapse-in-review.php
2 SkyCity Entertainment Group Limited Interim Financial Statements for the six month period ended 31 December 2020.
3 NZS 3910:2013, cl 8.1.4(c).
4 The comparable provision under the CCLA requires that the contract must have become "impossible to perform" or "otherwise frustrated". CCLA, s 60.
5 CCLA, s 67, and *Planet Kids Ltd v Auckland Council* [2013] NZSC 147.
6 *Planet Kids Ltd v Auckland Council* [2013] NZSC 147.
7 Ibid.
8 Ibid.
9 *Bank Line Ltd v A Capel & Co* [1919] AC 435 at 452; *Paal Wilson & Co A/S v Partenreederei Hannah Blumenthal* [1983] 1 AC 854
10 CCLA, s 24.

Case Law Update

New Zealand

KME Services NZ Pty Limited v CPB Contractors Pty Limited [2021] NZHC 212

A recent High Court decision held that a head contractor was not required to act in good faith when choosing whether to exercise a discretionary power under a construction contract. It also reiterated that terms will only be implied into a contract where they are necessary, and where they do not conflict with express terms.

Background

CPB was head contractor for the construction of a building at Christchurch Hospital. CPB engaged KME as a subcontractor to undertake electrical work. Completion of the work was significantly delayed.

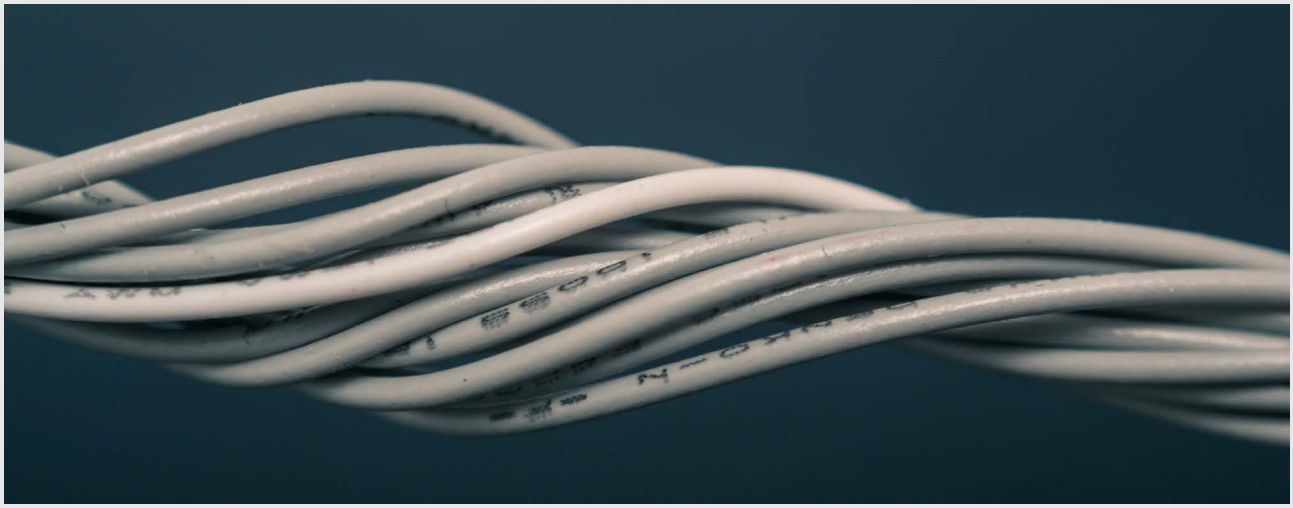
The parties' contract included two relevant pathways for extensions of time (EOTs). By one route, KME could submit a claim for an EOT. Provided it met certain preconditions, including strict notification timing requirements, it would be entitled to the EOT. CPB separately held an absolute discretion to unilaterally grant an EOT from time to time for any reason.

During the course of the project, KME applied to CPB for two EOTs. It did not adhere to the timing preconditions. The claims were rejected.

KME was aggrieved at the rejection of its EOT claims, and filed court proceedings against CPB, claiming around $10 million in time-related costs. It said:

- When exercising its discretion to unilaterally grant EOTs under the contract CPB was, by reason of an implied term, to act "in good faith, reasonably, consistently and not capriciously". It said CPB failed so to act in rejecting its claims.
- Alternatively, that CPB had implied obligations to enable KME to complete its work on time, including by giving KME access to the worksite and by appropriately managing other contractors and construction planning. It said CPB had breached those implied obligations, and that KME was accordingly entitled to damages for the delays.
- That the EOTs KME had submitted were valid despite not meeting the timing preconditions. It said that those requirements were not absolute and, in any event, had been waived by CPB.

CPB applied to have KME's claims struck out or, alternatively, for summary judgment in its favour.



Outcome

No good faith obligation

- The court held that there was no implied term requiring CPB to act in good faith in exercising its discretion. Such a term was not necessary to make the contract work and was inconsistent with a number of the contract's express terms.
- Reading a good faith obligation into the discretionary EOT mechanism under the contract would give KME the right to seek an EOT at any time, without needing to meet any preconditions at all. This would be inconsistent with the primary EOT pathway which required KME to adhere to certain timing requirements.
- This claim was struck out.

No implied terms creating entitlement to damages

- The court held there was no implied term giving KME the right to claim damages.
- The terms KME sought to imply were inconsistent with a number of other terms and obligations expressly set out in the contract. Implying them would give KME a right to damages for delay where none otherwise existed.
- The contract's EOT regime was the method by which the parties had agreed that any project delays should be addressed. The fact that the regime did not entitle KME to costs associated with EOTs was a deliberate apportionment of risk.
- This claim was struck out.

No waiver

- The court held that there had been no waiver.
- To show that the timing conditions had been waived, KME needed to present evidence of a clear and unequivocal representation by CPB to that effect. KME had not done so.
- CPB was entitled to summary judgment in its favour for this claim.

Takeaways

- New Zealand courts generally approach arguments as to 'good faith' implied terms in the same way as English courts, rather than Australian courts. There is a relatively high bar to establishing such a term, especially in contracts negotiated by sophisticated commercial parties.
- While it will sometimes be possible to imply a requirement that a discretionary power be exercised only in good faith, it is unlikely to be implied where doing so would conflict with the contract's express terms, or where the contract can function just as well without it.
- The more inflexible the framework around applications for extensions of time, or variations, the less likely the court will be to imply terms which have the effect of watering down that inflexibility.

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Case Law Update

Singapore

Sandy Island Pte Ltd v Thio Keng Thay [2020] SGCA 86

The Singapore Court of Appeal has held that a property owner's failure to comply with a defects liability clause in a construction contract will not automatically extinguish the right to recover damages for the cost of those defects.

Background

Sandy Island Pte Ltd was the developer of a collection of waterfront villas located in Sentosa Cove, Singapore (Developer). Thio Keng Thay purchased one of the villas.

The sale and purchase agreement contained a defects liability clause (DLC) which required the Developer to make good, at its own cost and within one month, any defect which became apparent within the 12 month defects liability period. It also provided that Mr Thio was to give the Developer the opportunity to arrange for any rectification work before he engaged a third party to do so.

Soon after taking possession, Mr Thio notified the Developer of multiple defects at the property, many of which were serious. The Developer offered to rectify the defects, but Mr Thio was dissatisfied with the work it proposed by way of rectification. He refused to grant the Developer access to the property to undertake it. Mr Thio engaged a new contractor to carry out the work, then sought to recover all associated costs from the Developer by way of damages.

The first phase of the High Court trial was to address liability only. The court held that the Developer had breached its contractual obligation to build the villa in a good and workmanlike manner, but that Mr Thio had acted unreasonably in denying the Developer access to perform the rectification works. However, the Judge concluded that Mr Thio nonetheless retained a common law right to claim damages.

The Developer appealed the decision. It submitted that:

- The DLC operated as an exhaustive code. Mr Thio could not claim damages unless he had met the conditions of the clause.
- By preventing the Developer from exercising its right to arrange for the rectification itself, Mr Thio had breached the DLC. He was accordingly unable to claim damages in relation to the defects.

Outcome

The Court of Appeal upheld the decision of the High Court.

- The DLC did not operate as an exhaustive code. Its purpose was to allow the Developer the opportunity to remedy those defects that became apparent during the 12 month period, and could be rectified within one month. A wide range of defects would not be captured by the clause, including those which took more than a year to be identified, or which took longer than a month to resolve. The DLC also did not account for circumstances where a property owner wished to engage another contractor to rectify defects as a result of losing confidence in the abilities of the original contractor.
- There was nothing within the DLC to suggest Mr Thio had agreed to give up his common law rights.
- On the court's interpretation of the clause, Mr Thio was not required to comply with it before being entitled to seek damages.

The court noted that Mr Thio's actions in preventing the Developer from rectifying the defects were likely to affect the quantum recoverable (which is to be assessed during the second phase of the High Court trial). The court suggested that Mr Thio should not recover more than the amount which it would have cost the Developer had it been able to arrange for the rectification work itself.

Takeaways

It should not be assumed that the same conclusion would apply to the differently worded DLC provided for in the NZS 39 series of contracts. However, the case highlights a number of principles which would be relevant under New Zealand law:

- Defects liability clauses should be carefully considered when confronting defects which appear during the defect liability period.
- The presence of a defects liability clause in a contract will not automatically extinguish a party's common law right to claim damages for defects. If it is the parties' intention to limit liability in this way, that limitation should be clearly stated in the terms of the contract.
- Where work is defective, where practicable it is best practice to give the party who undertook that work the opportunity to rectify it, even if the contract does not explicitly require it. Failing to do so may affect the liability of the contractor, or the quantum of damages recoverable.

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