

## NZLS - Construction Law Update

30 July 2019

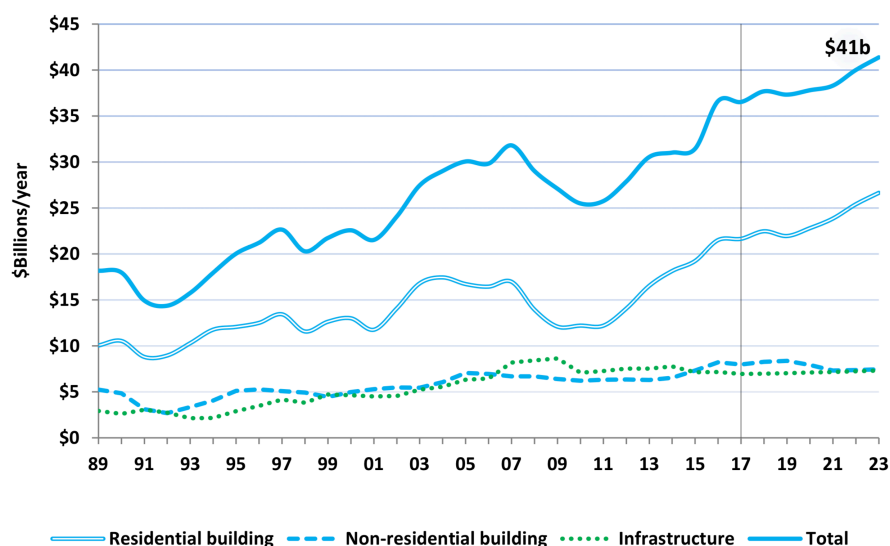
*We as designers, clients and constructors need to establish a much stronger foundation of behavioural principles to guide our decision making. We need to reset the culture in order to lift our performance.*

Peter Reidy, Chair Accord Development Group  
CEO, The Fletcher Construction Company

### 1. Introduction

In MBIE's National Construction Pipeline Report 2018, the forecast for growth was bullish, but perhaps not unrealistic.

Figure 2-1 All building and construction nationally, by value



Source: BRANZ/Pacifecon/Statistics New Zealand

One does need to take into account that the forecast includes in its residential projections the Government's commitment to deliver 100,000 quality, affordable KiwiBuild homes over the next decade, and that the pipeline did not take account of the inability of the industry to meet those projected demands. The continued failures of construction companies, like Ebert, Arrow and others, and the ongoing announcements of losses on projects by the dwindling number of construction companies willing or able to take on major projects all suggest that something is not right; MBIE's projections of last year might not make it through to this year's update.

**John G Walton**

Commercial Barrister and Mediator

—BANKSIDE CHAMBERS

**Russell  
McLeagh**

The Construction Sector Accord, quoted above, contains the right message; its success or failure will depend on the willingness of the Government and its advisors to put its bold words in to practice.

Much of the development of the law and construction practice, since this seminar was last delivered, turns on insolvency and enforcement of contractual obligations. What it also highlights is a failure by clients and legal advisors to understand that best for project outcomes do not always reflect the most aggressive transfer of risk to the contractor.

As the saying goes, "there's no such thing as a free lunch".

## **2. State of the industry**

It is well documented that the construction industry faces an increasing trend in insolvency-related disputes, labour and material shortages, higher costs and lower margins. Disputes within the construction industry also appear to be on the rise.

The recent Russell McVeagh publication "Getting it right from the ground up" surveyed members of the construction industry to further explore the key risks that are driving construction disputes in the industry. Over 60% of the survey respondents believed disputes in the construction industry have been on the rise for the last two years and over 70% predicted an increase in disputes over the next two years. The survey found that some causes appeared to be structural to the industry (for example, skill shortages) but others were in the parties' control; for example, risk allocation, contractual terms and relationships between the parties.

This paints something of a crisis point for the industry, but also one which – on its present course – seems likely to get worse. The Construction Sector Accord signed by the Government and industry leaders in April 2019 appears to be an attempt to address some of these issues.

Despite the many issues within the industry, there appears to be steady growth in terms of projects. One of the key findings from the National Construction Pipeline Report 2018 was sustained growth forecast for the building and construction nationally. The Infrastructure Transactions Unit's pipeline prototype (that will show what projects will be delivered by major central government agencies over the next five years) has identified 174 projects, with an estimated value of over \$6.1 billion as having funding certainty, or near certainty, in the pipeline.

In light of the above, unless something changes dramatically, practitioners can expect to see more construction-related disputes, more insolvency cases and clients with greater concerns about cash flow. It will be important to advise clients on using clear contractual terms, quality design documentation and appropriate risk allocation at the start of a project in order to minimise the risk of disputes later down the track.

### 3. Early intervention

*It seems to be the practice in the construction industry to employ consultants to prepare a claim almost as soon as the ink on the contract is dry.<sup>1</sup>*

The construction industry is unusual for the value of the work carried out under arrangements which lack certainty as to the design of the work, its price or time of delivery. In that context, construction contracts must legislate for that uncertainty by providing a framework for carrying out the work, paying for it, and stating the parties' rights and obligations so that disagreements can be dealt with fairly and predictably.

While Lord Justice Lloyd's comments from *McAlpine*, quoted above, may appear overly cynical, when the extent of uncertainty inherent in construction projects is combined with an aggressive risk transfer, designed to achieve price certainty, and a competitive tendering process, some level of disagreement is inevitable. Most contractors will be focussed on protecting what margin they have left after the tender process, and will be keen on lodging claims, while the owner will be under the misapprehension that "fixed price" means that they don't have to pay more than had been agreed in the contract.

Notwithstanding the popularity of "lump sum", "fixed price", "guaranteed maximum price" or GMP contracts and the like, construction prices are never actually fixed or guaranteed. Any construction contract will provide for compensation of additional time and money for one or all of the following:

- (1) changes instructed by the owner, or other act of prevention or delay by or on behalf of the owner
- (2) design development which is inconsistent with what the contractor provided for in its pricing
- (3) unforeseen changes – consent and regulatory environment, unexpected ground conditions or existing buildings not being what was expected
- (4) *force majeure* – not strictly a legal concept, but defined in most contracts

The common thread in such events is that (a) they were beyond the control of the contractor and could not reasonably have been anticipated, and avoided or priced for, at the time of tendering, and (b) they cause cost or delay which would be unreasonable for the contractor to carry. Implicit in this is the concept that the employer or principal owns the project – it is their project, not the contractor's; the owner will either occupy the completed work (in the case of residential construction) or generate income from it (in the case of commercial developments). The contractor is simply supplying, constructing and installing what the owner has paid for.

Another way of putting this is that apart from making a profit (a reasonable expectation) and reputational damage in failure, the contractor has limited interest in the project

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<sup>1</sup> *McAlpine Humeroak Ltd v McDermott International Inc (No. 1)* (1992) 58 BLR 1 at 24 per Lloyd LJ

outcome. Simplistically, the contractor's primary concern is anything that puts payment for work done (including margin) at risk. The most common events are unforeseen events and changes to the work. Most contracts will provide a notification procedure for such claims, with consideration by either the owner or its agent, the Engineer.

Once a disagreement has occurred, most contracts provide for a number of resolution procedures; in the case of NZS3910:2013:

- Engineer's formal decision
- Statutory adjudication under the Construction Contracts Act 2002
- Mediation/Expert determination
- Arbitration

Typically, while these are styled "dispute resolution" provisions, they rarely actually "resolve" the dispute. Contractor's dislike issuing disputes notices, and by the time they are issued, relationships on site will almost certainly have soured. This is in part a reflection of the failure of trust between the parties at an operational level, and the stress for contractors not being paid and owners, often very inexperienced in construction, fearing they are getting ripped off (and perhaps becoming under financial pressure as a result of cost overruns).

While it is easy to point the finger of blame, or to suggest that the designs may have been more complete at the time of tender, or more thorough site or building investigations undertaken, that is so much spilt milk. A cost has been incurred, and it is looking for a home.

As each tier of dispute resolution is worked through, the Engineer has some level of trust as an independent professional; however, the Engineer is also almost certainly responsible for any design errors or deficiencies (the Engineer is the agent of the owner, after all);<sup>2</sup> statutory adjudication can be expensive, and an adverse decision more than a little inconvenient; and arbitration viewed as being as expensive, as uncertain and at times as slow as court litigation. More critically, the parties commit resources and incur expenses at each stage which would be better employed in their core businesses, and the relationship cost is high. Save for the most sophisticated contracting parties, issuing a disputes notice is perceived as a declaration of war, with a corresponding deterioration in relationships at all levels of the project.

At risk is the contractor's reputation and the owner's asset. It is the norm that, if a contract is terminated, the work in progress will not be worth what has been paid to date and the cost of engaging another contractor to complete the work can be numbing. Except in the most egregious cases, projects are better completed than stalled by the sacking of the contractor, or worse abandoned.

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<sup>2</sup> See *Sutcliffe v Thackrah* [1974] AC 727

From a litigation perspective, it is often said that the best time to mediate is once discovery has been completed and the parties' respective cases crystallised. This is typically poor advice in construction.

The first priority is to keep the contractor on site and working, and for the disagreement to be corralled to avoid poisoning the work on site. This traditionally has been the role of the Engineer, but the complications of an inescapable conflict of interest has made this largely ineffective, particularly in larger projects.

The accepted approach to dispute resolution in the construction industry is to identify the potential for disputes early, and to try to resolve those disagreements before positions harden.

One technique, formalised in the New Engineering Contract (now in version 4, with the NEC4 form of Engineering and Construction Contract), is to provide for a risk register, identifying project risks, estimating their likelihood and severity of consequences if they eventuate. The risk register is then a project document, updated by the project manager on the initiative of either party, to reflect real time risks to the project. The objective is to avoid or mitigate the effects of such risks early in a non-confrontational way. The risk register is prepared in draft by the owner, and the contractor reviews and proposes modifications to the risk register during tender. Immediately following award, the parties have a risk meeting where the risk register is workshopped, and the likelihood of risks and responsibility for avoiding them is discussed.

For risk registers to work, there are a number of core requirements:

- (1) the risk register must be a complete and honest assessment of risks to cost, quality and time
- (2) all parties must feed into the risk register and it must be a real time reflection of project risk – either party must be able to call a risk meeting (styled an early warning notice in NZS3910:2013)
- (3) the parties must resist including an "allocation of risk" column in the risk register. While tempting, and understandable, it raises the prospect that the parties have agreed an allocation of risk which cuts across the more carefully drafted provisions of the conditions of contract. Action required is a preferable description, leaving unmodified the contractor's entitlement to claim for cost, or not, under the allocation of risks in the contract conditions.

For major projects, primarily tunnelling, the risk register is accompanied by a disputes board. Such boards take a number of formats, whether Disputes Review Boards giving non-binding opinions; Disputes Adjudication Boards (as in the FIDIC forms of contract), which decide disputes; or Disputes Avoidance Boards (as in the London Olympic and Crossrail projects), which focus on dispute avoidance, as their name suggests:

- the board is convened at the commencement of the project with independent industry experts, and they call the first risk meeting

- typically, the board is copied with all formal contract communications and progress reports, and is entitled to attend all progress meetings – for this, they are paid a retainer
- when a dispute arises, or the potential for a disagreement identified, either party may refer the dispute to the board for consideration, or in some cases the board may initiate a review meeting

In each case, the board's role is to provide or promote a prompt and fair resolution to the dispute as early as possible, in order to maintain progress on the site and to provide what will hopefully be a workable solution before costs escalate.

A simplified, one person, version of the Disputes Board is CEDR's Project Mediator.

#### 4. Options for when a dispute arises

*229 If a builder build a house for some one, and does not construct it properly, and the house which he built fall in and kill its owner, then that builder shall be put to death.*

*230. If it kill the son of the owner the son of that builder shall be put to death.<sup>3</sup>*

##### *Engineer's decision*

Under NZS 3910, the Principal or Contractor may give notice requiring the Engineer to give a formal decision. Upon receiving such notice, the Engineer must give a formal decision within 20 working days. Alternatively, the Engineer may, at any time, on their own initiative give a formal decision in respect of the dispute (unless the dispute has been referred to an agreed expert). The Engineer's formal decision is final and binding, subject to any mediation, arbitration or adjudication proceedings.

Advantages of an Engineer's decision include:

- **Efficiency:** an Engineer's decision is a relatively quick and cost-effective way of resolving a dispute.
- **Experience:** an Engineer will be familiar with the contract and project and will generally have considerable experience in construction matters.

Disadvantages of an Engineer's decision include:

- **It is not final:** an Engineer's formal decision is subject to any mediation, arbitration or adjudication proceedings (provided it is challenged promptly).
- **Perception of bias:** under NZS 3910, an Engineer has a dual role. They are not only an expert adviser and representative of the Principal, but must also act independently of both the Principal and the Contractor in making decisions entrusted to them under the contract. The contractual terms of NZS 3910 require the Engineer in making such decisions to act "fairly and impartially". However,

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<sup>3</sup> The Code of Hammurabi: <https://sourcebooks.fordham.edu/ancient/hamcode.asp>

rightly or wrongly, the Contractor will often regard the Engineer as tending to side with the Principal.

### *Mediation*

A mediator consults impartially with the parties to assist in bringing about a mutually acceptable solution. A mediator does not impose a decision on the parties but assists them to reach their own settlement. NZS3910 has an unusual provision for the mediator to issue a "decision" if requested, and for that decision to become binding if not rejected within 10 working days.

Advantages of mediation include:

- **Maintaining the business relationship:** the facilitative nature of mediation (as opposed to the adversarial nature of arbitration) can help to maintain a business relationship. This is particularly important if the project is ongoing.
- **Efficiency:** mediation is relatively quick, with mediations usually lasting 1-2 days. It is also considerably less costly than arbitration. As stated above, there is usually no good reason to wait until after discovery before mediating.
- **Acceptable outcome for both parties:** a mediator will encourage the parties to find a solution to the dispute which will suit both the parties' needs. They are able to fashion creative solutions that no arbitrator can.
- **Resolving disputes:** although the mediator's decision is agreed to be non-binding, parties can use it as a springboard for further negotiation. It can help to break a deadlock, as it will help both sides better understand each other's position (in terms of both the strengths/weaknesses of their respective case and the underlying commercial interests/objectives).

Disadvantages of mediation include:

- **Efficacy:** the parties may not be in a position to reach settlement early on in the dispute resolution process. If the parties do not come to an agreement, the dispute will remain unresolved and the cost of mediation will have been wasted.
- **Disclosure:** there is a potential concern that parties may disclose an important aspect of their argument or commercial position, which (despite the confidential nature of mediation) could benefit the other party if the matter went to trial. It is important to note, however, if a party has a strong case then disclosure is likely to assist settlement.

### *Expert recommendation*

An expert recommendation is specific to NZS 3910 under clause 13.2.3. Clause 13.2.3 provides that if all the parties agree, a dispute or question can be submitted to an agreed expert for the expert to make a recommendation.

That, of course, would be true even if the clause was not in the contract. The parties can always agree on their own way of resolving things. But clause 13.2.3 is there as a reminder for the parties to think creatively about how they might sort out their differences.

In the right case, an expert's recommendation would be a sensible option. For example, if:

- the Engineer's decisions were not trusted by one or other party;
- the issue was out of the Engineer's area of expertise; or
- the Engineer was getting overwhelmed with the volume of matters being referred to them.

However, we have not seen expert's recommendations used often. And it is only going to be worth it if there is a good chance that the resulting expert's recommendation will be followed. Most obviously:

- if the parties have particular regard for the expert; or
- if there is not enough money at stake to take the matter any further.

Advantages of an expert recommendation include:

- **Technical issues:** an expert recommendation is well suited to resolving technical disputes which underlie many construction disputes (e.g. delay analysis, cost estimation, geotechnical, survey, or engineering). Referring the technical element of a dispute to an independent expert for determination can substantially shorten the dispute process and help to preserve relationships.
- **Efficiency:** an expert recommendation is usually considerably quicker and less costly than other dispute resolution mechanisms such as arbitration.
- **Resolving disputes:** although an expert recommendation is agreed to be non-binding, as with a mediator's "decision", the parties can use it as a springboard to resolve their dispute.

Disadvantages of an expert recommendation include:

- **Enforcement:** an expert cannot take enforcement steps (enforcement needs to be sought through the Courts).
- **Limited appeal rights:** there are limited or no appeal rights, and very limited grounds to set aside an expert's recommendation. The use of an expert is much less tied to legal processes so it more difficult to challenge the recommendation.

### *Adjudication*

Adjudication is a process in which a neutral third party gives a decision on a dispute. It is a unique fast track statutory dispute resolution process for resolving building and construction disputes under the Construction Contracts Act 2002. Adjudication is intended to result in quick, enforceable decision to disputes which arise in the course of a project – so the parties can put the issue behind them and get on with the build.

For any construction contract, either side may refer their dispute to adjudication at any time. The dispute does not have to be about money. It can cover any questions in dispute about the rights and obligations of the parties under the contract. So it might, for example, be about whether liquidated damages apply, or about how they should be calculated.



Advantages of adjudication include:

- **Efficiency:** adjudication is quicker and less expensive than arbitration or litigation, because it is designed to ensure that cash flow is maintained during the construction process. Many disputes referred to adjudication are resolved in less than six weeks from the time the process is initiated.
- **Practical finality:** Although it is still possible to go to mediation, arbitration or Court following an adjudication, in most cases the decision of the adjudicator decides the dispute.

Disadvantages include:

- **No effect on third parties:** Third parties cannot be joined to an adjudication. An adjudication determination cannot affect third party rights and/or property (with the exception of an applicant seeking a charging order in respect of a construction site owned by an "associate" of a respondent).
- **Enforcement:** an adjudicator cannot directly take enforcement steps (enforcement needs to be sought through the Courts).
- **Finality:** Section 26 of the Construction Contracts Act 2002 provides that nothing in the Act prevents the parties from submitting a dispute to another dispute resolution procedure whether or not the proceedings for the other dispute resolution procedure take place concurrently with an adjudication. Accordingly, the decision of the adjudicator is provisional and will be binding on the parties until the dispute is finally determined by arbitration or by court proceedings, or resolved by agreement or mediation after the dispute is determined by the adjudicator.

However, in our experience, in New Zealand matters are not always referred for a speedy resolution when they arise. Instead, they are often stockpiled by the Contractor for a big global negotiation when it presents its final account. Therefore, the promise of adjudication is not being fully realised. This contrasts with the general approach in England and Wales, where it is fairly common place for there to be one or more adjudications in the course of a build, long before the final account.

A possible counter to the stockpiling strategy is for the Principal to take the initiative. The Principal does not have to sit back and wait for the Contractor to refer matters to adjudication. In the appropriate case, the Principal may well want to refer them itself.

There are some real advantages to being the party who refers the dispute, for example:

- You get to set the question. This is a powerful advantage. For example, if there were 10 variation claims presented by the contractor and the Principal was arguing that they were all time-barred, it could pick the best examples of time-barred variation claims and refer those claims alone to adjudication for resolution. If the hoped for answer came back, it would be leverage in negotiating the remaining balance.
- You get to prepare your claim and your evidence at your leisure and decide when to refer the dispute to adjudication. Once this occurs, the responding party has to

put together a response in the short period that they are given (of 5 days - or more if agreed to).

### *Arbitration*

Arbitration is another alternative to litigation and is a process in which the parties agree to refer the dispute to a third party, the arbitrator. Arbitration is governed by the Arbitration Act 1996. Most construction contracts require parties to refer any dispute to arbitration rather than to Court.

Advantages of arbitration include:

- **Choice of decision-maker:** the parties have a greater degree of control over the appointment of the arbitrator(s). Parties can select experienced arbitrators with specialist expertise in the subject matter of the arbitration.
- **Procedural flexibility:** the parties to an arbitration have considerable autonomy to determine the process of the arbitration, which provides greater procedural flexibility than that available in the Court process. This includes a more streamlined discovery process, efficient case management (resulting in an earlier hearing) and the relaxation of the rules of evidence.
- **Efficiency:** arbitration can be quicker and less expensive than Court, if managed appropriately.
- **Confidentiality:** arbitral proceedings are subject to statutory confidentiality (although any subsequent appeal to the Court is not).
- **Finality:** there are limited appeal rights (if any) and very limited grounds to set aside an arbitral award.
- **No adverse precedent:** arbitral awards are not binding on subsequent arbitrators (or the Court), so there is no risk of a binding adverse precedent (although there is a "practical" precedent risk).
- **Commonly accepted:** arbitration agreements are commonly accepted in construction contracts and counterparties will likely require good reasons to remove them.
- **Overseas enforcement:** arbitral awards are recognised in countries that have ratified the New York Convention, and may be easier to enforce than Court judgments if there is no reciprocal enforcement of judgments regime that applies.

Disadvantages of arbitration include:

- **Effect on third parties is limited:** third parties can only be joined to arbitral proceedings with their agreement (or through consolidation of two or more arbitral proceedings). Arbitral awards cannot affect third parties' rights and/or property, nor can they bind third parties.
- **Parties bear costs:** where arbitration is properly managed it is possible for arbitration to be more efficient in terms of both time and cost. However, often that is not the case. As the parties have to bear the cost of the arbitration, arbitration may not be a cost effective option where the amount in dispute is relatively low. Indeed, legal costs can often equal those in Court proceedings.

- **Limited precedent value:** arbitral awards are not binding on subsequent arbitrators (or the Court), so there is no benefit of a binding positive precedent (although some benefit of a "practical" precedent).
- **Limited appeal rights:** there are limited or no appeal rights, and very limited grounds to set aside an arbitral award.
- **Enforcement:** an arbitral tribunal cannot directly take enforcement steps (enforcement needs to be sought through the Courts).
- **Process disputes:** as arbitrators' powers are derived from the parties' agreement, disputes can arise as to interpretation of process provisions.
- **No statutory processes:** statutory processes such as summary judgment and strike out applications are not necessarily available through arbitration (unless the parties agree).

## 5. Termination

Leaving to one side the common law distinctions between conditions and warranties, and the consequences which flow from breaches of them, section 34 of the Contract and Commercial Law Act 2017 entitles the parties to a contract to provide their own remedies for breaches of contract, repudiation and misrepresentation.

In lieu of such contractual remedies, the Act provides for cancellation in the event of repudiation (section 36) and misrepresentation or breach of an essential term (section 37). The threshold for cancellation under the Act is the breach of an essential term which substantially reduces the benefit or increases the burden on the non-breaching party.

Most construction contracts contain default provisions, providing for notice of breach, cure periods and then termination. Where the owner terminates, NZS3910 provides for the use of the contractor's equipment to complete the works, and the recovery of any cost overrun following completion.

The termination provisions were recently considered in some detail by the Court of Appeal in *Custom Street Hotel Ltd v Plus Construction Co Ltd* [2017] NZCA 36. In that case, the contractor, Plus, had perhaps unwisely provided a performance bond for 25% of the contract price. The owner, Custom Street Hotel, had delayed obtaining consents for the project to such an extent that time was declared to be "at large" in an adjudication. The contractor endeavoured, but failed, to agree a revised programme for the work and payments became in arrears.

The contractor issued a default notice, requiring payment within 10 working days. On the evening that the notice period expired, the engineer was in China. The contractor's project manager phoned the engineer, noting that the contractor intended to terminate the contract and requiring the engineer to suspend the work in terms of clause 14.3.3. The engineer pointed out that he was out of the country and unable to deal with the matter, and that he had already suspended work for safety reasons a week or so before.

Plus proceeded to terminate the contract by notice the following day. Custom Street Hotel disputed the termination, and issued its own notice for abandonment. Concerned that Custom Street Hotel would make demand under the bond, Plus advised the bond

issuer that any demand under the bond would be in breach of contract, and issued injunctive proceedings against Custom Street Hotel and the engineer, prohibiting the engineer from issuing the default certificate required under the contract and Custom Street from making demand. The parties settled those proceedings in favour of arbitration.

The arbitration turned on the particular question of whether or not the engineer could issue the certificate required under the bond. The bond itself was an on-demand bond, entitling Custom Street Hotel to make demand without proof or conditions as to default or the amount demanded under the bond. However, before making demand, the engineer was required to certify under the contract that there was default under the contract and that the amount demanded was "properly due" in terms of the contract.

The engineer issued a certificate to the effect that Plus was in breach of contract, its termination having been invalid and that it had abandoned the contract. On the issue of the amount due under the contract, the engineer relied on a report issued by his own firm, supported by a quantity surveyor's estimate, to the effect that the cost to complete would significantly exceed the amount of the bond.

The arbitrator found that Custom Street had failed to comply with the default notice, and that Plus had validly terminated, and therefore was not in default. In relation to the amount being properly due, the arbitrator found that in the circumstances of clause 14.2.4, Custom Street Hotel had to complete the works first, and the engineer then had to ascertain the amount of any cost overrun before any amount could become due.

Custom Street appealed to the High Court, and was unsuccessful. It then appealed to the Court of Appeal. At this point it is worth noting that the contract was signed in late 2013; there were three adjudications in 2014; the contract was terminated in early 2015; the arbitrator's award was issued in November 2015; the appeals (including two applications for leave) were heard in 2016; the Court of Appeal hearing was in late 2017, and the final judgment issued in early 2018.

The Court of Appeal made a number of significant findings:

- (1) *Suspension before termination* – the critical termination provision in clause 14.3.3 provides that if the principal fails to comply with a default notice within the 10 working day period, the contractor "may require the Engineer to suspend the whole of the Contract Work", and "*Following such suspension the Contractor shall be entitled ... to terminate the contract ...*"

The issue raised by Custom Street Hotel was that Plus had "required" the engineer to suspend the works before the notice period had properly expired (in the evening of the 10<sup>th</sup> working day, but before midnight) and the engineer had not suspended the works. Suspension was clearly a precondition to the entitlement to termination.

The arbitrator held that suspension was a mere formality, and could not be read as a precondition. In the High Court, Justice Gilbert declined to follow the

arbitrator's reasoning and held that the contract had been validly terminated in terms of the Contract and Commercial Law Act 2017. In the Court of Appeal, Kós P held both that suspension could not reasonably be a precondition, and that termination under the Contract and Commercial Law Act remained open to Plus, commenting at paragraph [37]:

*[37] ... We do not construe cl 14.3.3 as establishing a suspension condition precedent to termination. Defaults by the principal qualifying for suspension or termination under cl 14.3.3 all concern essential terms. We do not think the intention underlying the clause is that a contractor who has notified breach of an essential term, which breach has not been remedied within the requisite 10 working days, must seek (and achieve) suspension before exercising a right to cancel. Some questions might usefully be posed. What if (as here) the engineer does not act on the notice? What if (as also here) the works are already suspended (so that the act of suspension is practically immaterial)? Is the 10-day remediation period extended by notice to suspend? If so, how long for? If not, as seems likely, then what purpose is served in any case by requiring a notice of suspension which is immediately overtaken, a scintilla of time later, by a second notice — this time of cancellation?*

*[38] We see the purpose of cl 14.3.3 as clear. It creates a right to suspend, after 10 working days. But it is a right, not a requirement. The construction of cl 14.3.3 is informed by the retained right to cancel in the CRA. It makes little sense that a contractor that wishes to exercise that cancellation right must first go through a charade of "suspending" and see its right to cancel mangled or misplaced if the engineer does not perform his or her duty to suspend. As we see it, therefore, cl 14.3.3 must be read as creating a right to cancel once the right to suspend exists. And that "following such suspension" must be read accordingly: that the right to cancel is triggered once the right to suspend is triggered. They are not true alternatives, because the contractor may suspend first, and then cancel. But it need not seek suspension before cancelling. That is the most logical construction of the contract, consonant with the reasonable expectations of the contracting parties.*

It followed that Plus had validly terminated the contract, and could not then be in breach of contract, by virtue of abandonment as argued by Custom Street Hotel in justification of its own notice of default.

- (2) *Was the amount certified by the engineer "properly due" under the contract* – this question involved the proper construction of clause 14.2.4.

Clause 14.2.4 provided that, following termination of the contract by the principal for breach, the principal could elect to carry out the works, and the engineer would then "enquire into the Cost to the Principal of completing the Contract Works ...". The question then was, could Custom Street recover the additional

cost of completing the works before the works were actually completed. The Court of Appeal held that on any estimation of clause 14.2.4, the works had to be completed first.

It followed therefore that the engineer could not have certified either that Plus was in breach of the contract or that the amount claimed was properly due under the contract. The bond moneys were ultimately released to Plus.

It is not often that standard conditions of contract like NZS3910 get the benefit of judicial consideration in New Zealand, and the Court of Appeal's interpretation of the critical terms relating to termination and recovery of the cost of completion is refreshing.

## **6. Performance Bonds**

The Court of Appeal decision of *Richina Pacific Ltd v Samson Corporation Ltd* [2018] NZCA 132 gives us a better understanding regarding the interpretation of performance bonds. In 2010, Vero Insurance Ltd (now AAI Ltd) issued a \$2 million performance bond as part of a construction contract between Mainzeal Property & Construction Ltd and Samson Corporation Ltd. Richina would indemnify AAI for payments made under the bond. The bond stated that it would be "null and void" if Mainzeal "duly carries out and fulfils all the obligations imposed on [it] by the Contract Documents prior to commencement of the period of Defects Liability".

Part of the contract works included a car stacker. In 2012, a practical completion certificate was issued with the exception of the car stacker (which had not yet reached the performance standard required under the contract). The certificate stated that the bond would not be released until the car stacker was completed. After Mainzeal went into receivership in 2013 it stopped all work on the site without completing its obligations under the contract. The car stacker never met the performance standard required under the contract. Samson demanded payment of the bond from AAI. Richina applied to the High Court for a declaration that it was not liable to pay the bond. Samson counter-claimed for payment. Samson was successful in the High Court, and Richina and AAI appealed to the Court of Appeal.

The main issue on appeal was whether the bond was discharged when Mainzeal and Samson agreed to allow the engineer to certify practical completion on terms that expressly excluded the car stacker. The Court of Appeal held that the bond was not discharged on the issuing of the practical completion certificate. The bond would only be released if, at the time of practical completion, Mainzeal had duly carried out and fulfilled all of its contractual obligations. It had never done so. Therefore, the issuing of the practical completion certificate did not discharge the bond.

The Court rejected AAI's argument that the practical completion certificate was unconditional because the car stacker was treated as deferred works. The practical completion certificate was very clear that the car stacker was excluded but that it still had to meet performance standards by a certain date. The parties had agreed to defer practical completion for the car stacker and to authorize it for the balance of the works.

In doing so, the Court held that they treated the car stacker and the rest of the works as separable portions (not as a variation to the contract as the High Court had held).

The Supreme Court refused Richina's application for leave to appeal.

The recent High Court decision in *Arrow International (NZ) Limited v Bethell & ors* [2019] NZHC 1326 is also relevant to the proper construction of contractor's performance bonds.

The case arose from the insolvency of Arrow International (NZ) Limited. Arrow was engaged by the second defendant (NZ Project 29 Limited), a special purpose company which was developing a hotel in Wellington. Before the construction was complete, Arrow went into voluntary administration and was unable to continue with the works.

NZ Project exercised its step in rights under the construction contract and took on the task of completing the project itself. NZ Project had the benefit of a contractor's performance bond issued by AAI Limited, which it sought to draw on. It was on standard NZS 3910 terms, with some bespoke amendments.

The bond required AAI to pay on presentation of a certificate from the Engineer certifying that the contractor was in default and that the sum demanded was reasonable. Arrow's administrators objected to payment being made for various reasons including that the Engineer's certificate showed that the Engineer had not properly quantified the sums payable.

The Judge held that it was arguable that the Engineer had not carried out the proper quantification exercise required under the construction contract. However, the terms of the bond (and of the construction contract) showed that the parties intended that NZ Project should be entitled to payment even if there were such disputes as to whether the sums claimed were ultimately due.

In those circumstances, the Court was unwilling to go behind the Engineer's certificate unless it could not be treated as valid. The Court was not willing to treat it as invalid and was willing, instead, to infer that the Engineer had properly performed the necessary quantification, even though his calculations did not make that express.

The case emphasises the importance of construing the particular bond in question when determining whether its preconditions for payment have been met.

## **7. Insolvency**

Most litigators will be familiar with the various strategies for delaying payment of claimed amounts, whether by asserting that there is an arguable defence in summary judgment proceedings, or paying the disputed amount into court. These strategies are particularly relevant when there are doubts, real or imagined, as to the solvency of the party seeking payment. In many early cases under the Construction Contracts Act, Associate Judges were loath to order payment under an interim determination to a party in receivership, liquidation or possibly verging on either.



Under section 79 of the Act, in any proceedings for recovery of any amount due as a result of the payment claim/payment schedule process (sections 23 & 24) or an adjudicator's determination (section 59), the court *must not* give effect to any counterclaim, set-off or cross-demand. That provision lends a certain level of finality to an adjudicator's determination, subject to the *pay now argue later* ethos of the Act, expounded by Randerson J in *Volcanic Investments Ltd v Dempsey & Wood Civil Contractors Ltd* (2005) TCLR 256.

Conversely, a debtor commits an act of bankruptcy where it fails to honour a "*final judgment*" in terms of section 444 of the Insolvency Act 2006. The question then arises, is a failure to pay an amount due either as a result of the payment claim/payment schedule procedure or an adjudicator's determination final, in the sense that there is no defence to non-payment? This is particularly relevant where the merits of the claim have not been finally determined in arbitration or in court; notwithstanding the adjudicator's determination, or the failure to comply with the payment claim/payment schedule procedure. The defaulting party may have perfectly valid and legally justifiable reasons for not paying, and should therefore be able to avoid bankruptcy or winding up proceedings by raising an arguable defence or paying money into court.

In the seminal case of *Laywood & Reese v Holmes Construction Wellington Ltd* [2009] NZCA 35, the Court of Appeal laid this issue to rest. In the Court's view (Glazebrook, O'Regan & Arnold JJ, all either current or retired Supreme Court Justices), the obligation to pay under the Construction Contracts Act, and the unavailability of the normal defences in section 79, trumps all else:

[61] ... we prefer the view expressed by Randerson J in *Volcanic Investments*. We find some assistance in the exceptions provided for in s 79. Under that section, a set-off may be taken into account in debt recovery proceedings (including the s 73 process) if it relates to a liquidated amount and either judgment has been entered for that amount or there is no dispute between the parties in relation to the claim for that amount. Absent that, a determination can be entered as a judgment under s 73 and enforcement proceedings taken through the District Court, and any counterclaim, set-off or cross-claim must be pursued through separate proceedings.

[62] If that is the position in relation to the enforcement processes available through the District Court, or where there is a charging order under the CCA, there seems in principle to be no reason why it should not apply in respect of a bankruptcy notice under s 19(1)(d) of the Insolvency Act or a statutory demand under the Companies Act. It is true that such processes have an additional dimension to them, in the sense that ultimately they lead to a process which focuses on liquidity and asset worth. It is also true, as Associate Judge Doogue said, that bankruptcy and liquidation proceedings have a broader objective than simply ensuring that a particular creditor is paid. Despite that, bankruptcy notices and statutory demands are, in a practical sense, important enforcement mechanisms, as Randerson J recognised. And in the present case, the debt which *Holmes Construction* seeks to recover has the force of a court judgment behind it. This is not a case where a



*creditor has sought to use bankruptcy or liquidation proceedings to recover a small amount from a person or company which can plainly afford to pay it.*

*[63] If the contrary view were to be adopted, the efficacy of the s 73 process would, in our view, be undermined. Parties to construction contracts could refuse to pay an amount ordered by an adjudicator, and resist bankruptcy notices or statutory demands in relation to the debt, on the basis that they had a counterclaim, set-off or cross-demand. The effect of this would simply be to recreate similar problems to those which led to the enactment of the CCA, albeit in a different context.*

*Laywood & Reese* is a useful affirmation of the *pay now argue later* ethos of the Construction Contracts Act, which should remove any lingering doubt that even where the disputed payment is the final payment due under the contract, and there may be reasonable doubts about the solvency of the contractor (there were not in this case), a payment due under the Act must first be made. Sadly, we understand that no payments were actually made to Holmes Construction, the parties with solvency issues were in fact the trustees, Laywood & Reese.

This issue has been considered more starkly recently in the UK in the case of *M Davenport Builders Ltd v Greer* [2019] EWHC 318. In that case, the contractor issued what is referred to as a “smash and grab” adjudication under the UK’s equivalent of our payment claim/payment schedule procedure, and succeeded in getting judgment in its favour.

For its part, the owner resisted complying with the smash and grab determination on the basis that its own merits award had found in its favour. The High Court found that compliance with the first adjudication could not be stayed, and the owner had to pay the contractor. The unfortunate consequence of this is confirmation of the approach of the Court of Appeal in *Laywood & Reese*, that the owner had to pay the contractor, in this case in liquidation, and the owners then had to join the other unsecured creditors when it came to enforcing its own adjudication determination providing that a significant amount was to be reimbursed.

We would be surprised if a New Zealand court would come to a different conclusion.

## **8. Penalties and liquidated damages**

The Court of Appeal has recently considered the law of penalties in its decision of 127 *Hobson Street Ltd v Honey Bees Preschool Ltd* [2019] NZCA 122. In this case, the parties had entered into a regular deed of lease and a collateral deed. The collateral deed provided for the installation of a second lift in the premises. If the lift was not installed within 2 years and 7 months the landlord would indemnify the tenant for all obligations under the lease until its expiry. The lift was not installed in time. The landlord argued that the clause was an unenforceable penalty.

The Court held that the primary test for establishing whether a clause amounts to a penalty is the disproportionality test – whether the clause imposes a detriment on the promisor out of all proportion to any legitimate interest of the promisee in the

enforcement of the clause. The threshold for establishing disproportionality is high and will generally only be met if the clause is exorbitant or unconscionable. Indeed, there may be legitimate interests which justify a super-compensatory burden. Disproportionality can be checked against the punitive purpose test which assesses whether the predominant purpose of the clause is to punish the promisor rather than protect the legitimate interest in performance. However, the Court held these tests are "two sides of the same coin" and are both concerned with achieving performance expectations as opposed to enforcing penalties.

The disproportionality test supports freedom of contract and recognizes that the parties are likely to be the best judges of their own interests (particularly if they are commercial entities). As such, the bargains they have made and the remedies they have chosen should be upheld, except in cases of "gross overreach". The test signals a move away from a comparison between the likely loss to be suffered by a party and the stipulated sum as being determinative. Whilst this comparison may be relevant, the key question is whether the clause protects, and is not disproportionate to, a legitimate performance interest.

Applying this test to the case, the Court found that the clause did not meet the disproportionality test. The landlord failed to prove that the indemnity against the tenant's payment obligations until the end of the lease was disproportionate to the tenant's legitimate interests in the timely installation of the lift. Therefore, the clause was not a penalty and the landlord had to indemnify the tenant for all payment obligations until the expiry of the lease.

## 9. Contractual interpretation

Since Lord Hoffman broke new ground in the *West Bromwich* case,<sup>4</sup> battle lines have been drawn between those who favour the strict application of the words used in a contract and the parole evidence rule, without regard to the messy uncertainty of precontract communications and post award conduct.

In New Zealand, Justice Tipping lead the interpretive vanguard with his judgment in *Vector Gas*,<sup>5</sup> and from the sidelines retired Justice Thomas moaned that contract interpretation was going to hell in a hand basket. In the UK, judicial heavyweights, Lords Sumption and Hoffman, are battling it out in the legal press. While Justice Tipping's approach could be seen as a high point in contextual interpretation, and subsequent judicial comment could be seen to be scaling back that approach, by stressing the wider context of NZ's leading role in the debate,<sup>6</sup> the reality of judicial interpretation does not entirely support a "swing back to plain meaning" in our view.

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<sup>4</sup> *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896

<sup>5</sup> *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5

<sup>6</sup> Sees Bell Gully's Tim Smith and Sam Cathro's article in *LawTalk* 925, 8 February 2019 "The Interpretation of contracts" for a discussion of the issue.

If we take as a starting point Kós P's judgment in *Plus Construction*, the President clearly favours giving contract terms their plain meaning. He is not to be dissuaded from the clear wording of clause 14.2.4 by any arguments of "temporal" application to separate the intent of two clear sentences, one following the other. And yet, when it came to two adjoining sentences in clause 12.3.3, one entitling the contractor to be relieved of its obligations under the contract by requiring suspension of the works, and the next entitling the contractor to terminate "following such suspension", Kós P expressly recognised the contractual reality that the wording could not actually mean what it said. It made no "business sense", to use Justice Tipping's phrase, for the contractor to be at the mercy of the engineer's judgment when it came to something as fundamental as terminating the contract for breach. And quite rightly so.

We also see a certain level of judicial double speak.

In the *Honey Bees* decision referred to above, Kós P observes:

*Today, contractual overreach calls for assessment primarily through the lens of impaired consent, unconscionability, or consumer law infringement. That means there is less for the prohibition against penalties to do. Commercial parties should generally be left to the certainty of the bargains they have made, including the remedies they have elected collectively, save in the case of overreach.<sup>7</sup>*

His honour then went on to hold that the penalty provision in the development deed reflected the legitimate interest of the tenant, and there was no reason to use the law of penalties to interfere in what the parties had agreed.

When the issue of contractual interpretation came before the High Court in *Attorney-General v IPENZ & Reay*<sup>8</sup>, the Court had to review the Rules, Regulations and Code of Ethics of IPENZ in the context of whether or not the disciplinary procedures still applied to Mr Reay following his resignation from the Institute.

Justice Collins took the opportunity to review the prevailing cases of *West Bromich*, *Vector Gas*, and the Supreme Court's decision in *Firm PI 1 Ltd v Zurich Australian Insurance Ltd*<sup>9</sup>:

*While context is a necessary element of the interpretive process and the focus is on interpreting the document rather than the particular words, the text remains centrally important. If the language at issue, construed in the context of the contract as a whole, has an ordinary and natural meaning, that will be a powerful, albeit not conclusive, indicator of what the parties meant. But the wider context may point to some interpretation other than the most obvious one and may also assist in determining the meaning intended in cases of ambiguity or uncertainty.*

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<sup>7</sup> 127 *Hobson Street Ltd v Honey Bees Preschool Ltd* [2019] NZCA 122, at paragraph [29]

<sup>8</sup> [2018] NZHC 3211

<sup>9</sup> [2014] NZSC 147, at paragraph [63]

He concluded that the comments of the Supreme Court in *Firm PI 1* "reflect the modern approach to contractual interpretation, which considers text and context together to arrive at the intended meaning."<sup>10</sup>

So where does that leave us?

It is clear that there is considerable judicial unease that the courts could substitute its view of what should have been agreed for what the contract actually provides. However, the question remains, how much ambiguity or uncertainty must there be in the express wording of a contract for business common sense, the context of the contract or the conduct of the parties to intervene? The Supreme Court seems to accept that the clear and natural meaning is only part of the picture, as is apparent from the approach taken subsequently by both the Court of Appeal and the High Court.

In the construction industry, it is almost the norm that with standard conditions of contract, special conditions and technical specifications making up contracts of considerable size and complexity that the intention of the parties can be difficult to fathom. Often, the parties actually have no idea what they agreed on any particular point until a problem arises. Commercial context, customary practice and the conduct of the parties will always lend clarity to the words adopted by the parties to the contract, as Justice Collins observed in *IPENZ & Reay*, and sometimes, as in *Plus Construction* the words simply cannot mean what they appear to say.

## 10. Conclusion

*Endlessly refining existing conditions of contract will not solve adversarial problems. A set of basic principles is required on which modern contracts can be based.*<sup>11</sup>

There can be no question that the construction industry is at a crisis point; not just in the issues of availability of affordable housing and the homeless that keeps the *NZ Herald* presses humming and politicians pronouncing the latest solution and blaming previous governments.

While clarity and consistency in contract drafting is important, and it is clearly an issue, the solution to the pressures in the industry start with clients accepting that the risk of project failure rests firmly with them.

The courts have shown that they are committed to giving effect to the intentions of the parties, in the context of industry practice. What needs to be addressed is the greater definition of designs and project specification before tendering; adopting an appropriate procurement method; sensibly allocating risk for the project; drafting conditions which promote positive project outcomes; and providing for the early

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<sup>10</sup> At paragraph [82]

<sup>11</sup> *Constructing the Team*, by Sir Michael Latham, Joint Review of Procurement and Contractual arrangements in the United Kingdom Construction Industry, HMSO 1994

identification and management of disagreements before they degenerate into full blown disputes.



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