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## **AN ARBITRATOR'S PERSPECTIVE OF CONSTRUCTION DISPUTES AND THEIR CAUSES**

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## 1. Lack of Understanding of Basic Construction Law Concepts – Resulting in Deficiencies in Project Documentation

Sadly, many advisors have simply not understood some basic construction precepts. Equally sadly, this lack of understanding has often manifested itself in legal advisors to banks and other funders. Let me give you just a few simple examples.

### *Loss of right to liquidated damages*

During the 1960's and 1970's a body of law developed in England the gist of which was to the effect that if there was a provision for liquidated damages then an extension of time clause would be narrowly construed so that it did not extend to employer's fault unless it expressly said so. The reasoning was quite simple. If any employer could rely on its own fault to extend time and therefore preserve the right to liquidated damages, it would be taking advantage of its own wrong. An example of this principle in action is *Fernbrook Trading Co Ltd v Taggart* [1979] 1 NZLR 566.

Many people used to make jokes about the New Zealand Ministry of Works but as long ago as 1983 it issued a revision of PW64 (its then standard terms and conditions) which expressly included in the extension of time clause the right to extend time for any breach of contract by the employer. For some 15 years I subsequently said in numerous conference papers and annual lectures at a post graduation series run by the University of Auckland School of Engineering that it was essential to follow the lead of the Ministry of Works; that they had got it right and that any extension of time clause which did not expressly apply where the employer was at fault, would be negligently drawn.

Apart from acceptance by a handful of construction lawyers and the bigger engineering consultancy practices, the point was ignored. The result was an endless number of disputes where liquidated damages could not be recovered and time was legally set at large.

Even today, there are many lawyers who, I think, do not yet understand this very basic principle.

### *The right to manage delays*

A second example is the ability (or lack of it) on the part of an employer, engineer, architect or project manager to hurry a contractor along. This difficulty stems from other elderly cases in which it was held that, in the absence of an express or implied provision to the contrary, a contractor had an absolutely free hand as to how it managed its work. See *Construction Law in New Zealand*, Tomás Kennedy-Grant, Butterworths, 1999, at para 10.04.

As a result, standard forms of contract came to include an obligation to progress diligently with the works. Other terminology was used, but generally speaking most attempts to require the contractor to keep moving expeditiously were clumsily handled and difficult to enforce in practice. As a result, programme compliance obligations have become the norm, but these are only as good as the skill of those who draft them.

The problem becomes exacerbated when concurrent causes of delay arise, some being the fault of the contractor and some being the fault of the employer. In an important Canadian case, generally followed elsewhere, it was held in 1966 that where such concurrent delay occurs and it is not possible to accurately apportion responsibility for the delay, then the contractor is to get the benefit of the doubt and should receive an extension of time for the full amount of the combined delay; *Perini Pacific Ltd v Greater Vancouver Sewerage & Drainage District* (1966) 57 DLR (2 d) 307.

This led to standard forms being refined again but nothing seems to have emerged which satisfactorily deals with this problem.

An experienced “claims-minded” contractor, when confronted with a delay for which it is responsible, may procrastinate with catching up in the hope that a subsequent delay will be brought about by the employer. This could, for example, be as a result of the late supply of drawings or materials or the like. The contractor will know that as soon as a concurrent delay occurs which is the fault of the employer, it will not be too difficult to fudge the consequences of its own earlier default.

To deal with this common difficulty some of us devised, back in the 1970’s and early 1980’s a contractual regime with two specific requirements. The first was to give the employer an option to require a contractor to accelerate (at the employer’s expense) where the contractor was entitled to an extension of time. The second was to require the contractor to catch up delays for which it was responsible within a given period such as a month or other reasonable time acceptable to the engineer, architect or project manager.

My pet example of illustrating the importance of retaining the right to manage delays is the example of dewatering the foundations of a plant or a tower building project. A week of lost time (near the beginning) might be caught up by doubling the number of pumps at a cost of say \$10,000.00. If that week’s delay is not caught up at that time but has to be caught up in the final week of the project then the additional cost could be \$250,000.00 or more for exactly the same length of delay.

### *Variations*

Thirdly, the variations clause is often misunderstood. If circumstances arise within the ambit of the variations clause then the contractor is entitled to a variation. Importantly, the decision of the certifier must be made fairly and objectively, or the employer is in breach. Furthermore, the law is quite clear that even if a situation is not directly covered by the variations clause but the circumstances cry out for a variation (for example, any change in scope arising from a deficiency in design or a fault or breach on the part of the principal) then the law will often deem those circumstances to constitute a variation and an arbitrator can retrospectively grant a variation order from a certain date. These circumstances are becoming known as “deemed variations”. (See the line of reasoning adopted in **Brodie v Corporation of Cardiff** [1919] AC 337, **Holland and Hannen and Cubitts (Northern Limited) v Welsh Health Technical Services Organisation** (1983) 18 BLR 80, **State Rail Authority (NSW) v Boulderstone Hornibrook Pty Limited** (1988) 5 Building and Construction Law 117, and at 123 for a list of further authorities. In similar circumstances, where a variation order has been wrongly refused, the courts have found a remedy through the principles relating to unjust enrichment.) With this in mind, it is therefore utterly stupid to see provisions in contracts requiring the consent of a financier to any variation, or any variation above a certain monetary threshold. In fact, what is so dangerous about such a provision is that if a variation should be ordered (either because it is within the ambit of the variation clause or it is a deemed variation) but it is refused, then the contractor will have a number of remedies at its disposal not the least of which is an entitlement to damages; and the range of remedies may well extend to time being set at large and all rights to liquidated damages being lost.

### *Progress payments - valuation*

Under virtually every standard form of contract the contractor is entitled to progress payments based on a valuation of the works or percentage completed, or the achievement of a milestone.

(As a matter of passing interest, the Construction Contracts Act provides a statutory entitlement to periodic payments based on “ the value of the construction work carried out...”. Section 17 (1) (b)).

However, it is not uncommon for financing agreements (which are between the lender and the owner or developer) to limit progress payments to ensure that there will always be held back sufficient monies to complete the works. On most jobs, a traditional valuation approach and a cost to complete approach will coincide, or not differ greatly. However, on some projects a significant gap can develop and widen. If a contractor is clearly entitled to be paid on a value of work done or a percentage complete basis but monies are being held back

because the funder is reacting to a cost to complete approach then the employer is simply acting in breach of contract and the contractor can stop work or sue for damages. Of the many contracts which I have seen for recent developments in Auckland, I have on only one occasion seen a provision in a contract which expressly states that while progress payments will normally be made on a value of work completed basis, the funds are being drawn down on a cost to complete basis and if there is a difference the contractor has to live with it. That's fine, (although the effect of the Construction Contracts Act needs to be assessed.) The contractor was warned and tendered on that basis. But it is absolutely dishonest to administer a contract on a cost to complete basis without being entitled to do so.

One common feature of the above recommendations is that they are not unfair to the employer or to the contractor.

## **2. Lack of Adequate Design (Where There is a Traditional Form of Contract)**

For a long period of time it was standard practice to complete a detailed design before tenders were called. The scope of work was clearly defined and the pricing was likely to be fairly accurate. Considerable care was taken to get the design right because it was known that any changes would constitute a variation. Everyone knew where they stood – whether the design remained unaltered or not.

However, in more recent times, it has become quite common for work to be put out for tender when the design is far from complete and yet where the contractor is somehow supposed to live with the risk of what will turn up in the future in the designer's mind. Those who try to draft smart clauses to "stick" the contractor with that risk (for example, through "lump sum" or "GMP" techniques) are often behaving irresponsibly.

Your attention is drawn to the very important decision in **Multiplex Constructions Pty Limited v Epworth Hospital**, Court of Appeal of the Supreme Court of Victoria, 28 June 1996 (apparently not reported.)

This is a majority decision of Phillips and Charles JJ.A with Brooking JA dissenting. All three judges say that the case is unusual based on uncommon special provisions and it is probably for this reason that the case has not been reported.

However, contrary to the assumption of their honours, the case does reflect circumstances which, in principle, are all too common in the construction industry. Multiplex tendered a lump sum price of AUD52.975 million to do extensive work for Epworth Hospital. This included the demolition of some buildings, the refurbishment of others,

and the addition of new buildings including a large block for an additional 350 beds.

The variation clause started off in standard form but it concluded with an additional provision purporting to exclude from being a variation “any change/s or additional work/s caused by or resulting from the development of the design of the Works (including, without limitation, the development of the design for that part of the Works not documented or not fully documented as at the date of the Builders Tender and/or in the Design Development Drawings or the Design Development Specification(s).)”

There were other specific provisions making it clear that the Design Development remained incomplete and was to be fully documented; also; that “...the Contract Sum includes all allowances to fully compensate the Builder for all risks and contingencies (whether ascertained or not ascertained) and costs and expenses and any varied, changed or additional works caused by or howsoever resulting from the Design Development of the Works...”

The builder made a claim for over one thousand variations which it said were not caught by the exclusion relating to design development. The sum claimed was approximately AUD 3.4 million.

Twenty sample items (selected by agreement) were referred to the Special Referee. Four were withdrawn; of the remaining sixteen, eight were held to be variations, five were held to be covered by the exclusion clause and therefore not variations, and three were held to be variations in part.

The Special Referee decided that in respect of “aspects of works fully exposed in the tender documents, then it was only a “refinement” of this which was permitted at the expense of the builder. However, for those aspects in which “the design development process was incomplete or possibly not commenced at tender” additions or increases in the works might be, but not necessarily were, to be at the builder’s cost; each item was to be assessed on its individual merits.

(It was accepted that all changes would have been variations if the exclusionary provision had not been present).

The report was then the subject of argument before Byrne J who disagreed with the approach adopted by the Referee. Byrne J held that changes to the design did not fall outside the meaning of “design development” provided the **function** of a component part of the works was not altered.

He considered that only part of one alleged variation was truly a variation and the matter was referred back to the Referee who issued a second report adopting the approach of Byrne J.

On appeal to the Court of Appeal of Victoria, Brooking JA preferred the reasoning of Byrne J.

However the majority preferred, generally, the reasoning of the first report of the Special Referee.

As the majority decision summarised the position, "...the redesign of what has already been designed will fall outside the exclusionary proviso...". (And therefore, being something different from design development, was to be treated as a variation).

In my respectful opinion, the decision of the majority (and the Special Referee) is, unquestionably, correct. Somewhat ironically, the dissenting decision of Brooking JA commenced by saying, "The letting of construction contracts where design is the responsibility of the owner's architect or engineer and at a time when the design is far from complete is a common practice and one which gives rise to many disputes." He then quotes from **Dunham & Young's Contracts, Specifications and Law for Engineers, (fourth edition by J T Bockrath, pp249-50)** where the dangers of rushed and inadequate preparation of tender design documents is emphasised.

There is nothing wrong with seeking a price for work where the design is not complete; but the contract documents must not only reflect that position but have within them a fair mechanism for dealing with it. In fact, it is not too difficult to do so. It simply comes down to a careful definition of the scope of work intended to be covered by the original price.

### **3. Inadequate Definition of Scope of Required End Results (Where a Design Build Contract)**

Equivalent problems arise with design build contracts because many do not focus on the most obvious requirement – defining the end results.

A simple example can be given with regard to mechanical services. In a standard traditional form of contract, the specification would define the size and extent of the ducting, the exact type of the heating and cooling equipment, the capacity of the fans and all the other detail which would go to make up the system. In other words, the contractor could safely assume that if it didn't work it would be the designer's fault.

A design build specification for air conditioning need not address any of the matters just referred to. It should define end results: design life, future maintenance parameters, temperature range, air change frequency, and so on. Only then can the design build contractor be at fault if the system doesn't work.

Amazingly, a number of employers call for design build prices yet the specifications follow the traditional form of stating the method to be followed.

This recipe for certain trouble could not be more elementary to foresee and avoid yet it is hard to comprehend how even this basic concept is often not understood.

With design build contracts there will be a few – very few – aspects of work where the method needs to be defined.

#### **4. Lack of Understanding of the GMP Concept**

Of all the fashionable trends in construction projects, this takes the cake!

Where did the guaranteed maximum price concept originate? Not with anything we ever see in traditional buildings. Not with residential apartments, not with commercial premises, not with industrial premises, not with hotels, or anything similar.

The whole concept was developed in the field of civil engineering with complex projects where very sophisticated international contractors had better in-house expertise and design capability than most private consultants. It was in this setting that such contractors were willing to be bound to a GMP concept. This was because they had the skill to design the petrochemical plant, or design the sub-sea pipeline, or design whatever it was. If they were not the principal designer, they had significant design input, and always had the skill to reasonably foresee the ultimate scope of work.

Many consultants and lawyers thought they would do their clients a favour by introducing the same concept into every kind of construction project. However, because of the relative straightforwardness of many projects, most tenderers do not have any sophisticated in-house design capability. They simply cannot properly assess the final scope.

Developers and other employers have been wrongly/badly advised to call for tenders on a GMP basis (unless the project is one of those rare ones where it is appropriate). Many, (sometimes all) of the tenderers have no capability whatsoever of knowing what the maximum price might be or how to calculate it. The design is always incomplete at the time of tender (otherwise there is no need to even consider the GMP concept) so the whole process is usually a

nonsense. If the contractor fails to complete or goes under, the employer and the consultants have only themselves to blame.

The main problem with GMP contracts is that the scope of work (including end results) is not properly defined.

A good definition of end results is an essential feature of a GMP contract as it is for a design build contract. How an employer or its consultants, believes it can bring a traditional approach to bear (where the employer has full responsibility for design) and then thrust a guaranteed maximum price onto a contractor where the design is not fully developed and the contractor has no design skills, is simply beyond belief.

## **5. Funding Terms Which Can Strain or Jeopardise the Certification Process**

One has the impression that some financiers and their advisors feel that the position of a lender is best protected if the contractor is placed in a financial straightjacket regardless of what the final scope of work might be.

Such an approach overlooks the basics discussed earlier in this article. Such an approach displays ignorance of construction law. Such an approach will never ever succeed.

Hopefully, everyone understands that a construction project depends upon adequate funding; but “adequacy” depends on allowing not only for the information available to be priced, but also the cost of changes in scope, and the other inevitable problems which arise which increase cost. If the total available funding is what is perceived at the outset to be the bare minimum then it will never be enough.

Another harmful fashion is where the funding terms limit each draw down to a cost to complete basis when that is not the contractual basis for payments to the contractor. This has already been discussed.

The involvement of financiers in variation decisions can be a recipe for disaster, as discussed earlier, unless it is in a rational setting. Obviously, the involvement of financiers is justified if the variations relate to truly optional or discretionary changes. But a blanket requirement for financier approval to all variations simply displays a complete lack of understanding of the construction process and of construction law. In fact, it displays such a high level of ignorance that no true construction lawyer worth his or her salt would want to be associated with it.

An Australian tendency has shown signs of catching on here on occasions. That is the concept of the financier being a party to the construction contract. To be quite honest, I cannot get my head around the ramifications of this. It seems to me that it is an approach which must be fraught with danger unless carefully implemented.

## **6. A Lack of Understanding By Certifiers As To Their True Functions and Obligations**

It is very important to remember the number of people who rely on proper certification – the contractor, the financier, the employer, the owner (who may be different from the employer,) lessees, purchasers, insurers and probably others from time to time.

Interim Payment Certificates are of vital importance to the owner or developer as they are the official measure of the value of work to date. Those certificates are of vital importance to the contractor because they establish cashflow.

The Certificate of Practical Completion is important for other reasons. Up until that point, the employer is entitled to require full compliance with the contract (except for normal maintenance or remedial works.) However, once the Certificate of Practical Completion is issued the employer is deemed to have accepted anything which is obviously not in compliance with the contract. If the employer does not like the non complying work then the simple solution is for the certifier not to accept it. An example might be the type (as opposed to the quality) of any finishing, the colour of the roof unless it is immediately flagged as a maintenance item, and other things which might be different from what has been specified but which are plain to be seen. Too many certifiers try to have it both ways by certifying prematurely and then endeavouring to “stick” the contractor with something which should have been identified earlier as being unacceptable. Sometimes developers will acquiesce in or even encourage the premature issue of a certificate of practical completion so that they can uplift deposits from ultimate purchasers and enforce settlements.

In a nutshell, the certification process is often abused and this leads to many difficulties which can easily be avoided.

**WARNING:** In March 2001 the Singapore Court of Appeal handed down its decision in **Hiap Hong & Company Pte Limited v Hong Huat Development Co (Pte) Limited** [2001] 2 SLR 458. In a nutshell, the architect employed by the employer failed to issue progress payment certificates in a timely manner. In a judgment which seems to totally ignore well established principles adopted in most countries, the Court of Appeal held that there was no implied term imposing a contractual obligation on the employer to ensure the proper discharge by the architect of the certifying functions. Accordingly, where it was established that the architect was late in issuing interim certificates entitling the contractor to progress payments, the contractor had no claim to interest or other compensation against the building owner for loss of use of the monies that were received late.

(I am aware that some standard forms of contract specifically address this issue, as well as late payment of a certificate, (see, for example, clause 51.4 of the New Engineering Contract (UK),) but that is probably the situation in a minority of standard forms).

There was ample authority to justify the opposite decision. Examples are to be found in the cases cited earlier in relation to deemed variations. In addition, there is the very good decision of Judge Vinelott in **London Borough of Merton v Leach** (1985) 32 BLR 51, at 81:

“In **Holland Hannen and Cubitts v Welsh Health Technical Services Organisation** ...it was conceded that under the contract there in issue “...the building owner would do all the things necessary to enable the contractor to carry out the work” and His Honor Judge Newey clearly thought that that concession was rightly made. For the reasons I have given I think that this implied undertaking by the building owner extends to those things which the architect must do to enable the contractor to carry out the work and that the building owner is liable for any breach of this duty on the part of the architect.”

In addition, there is the compelling reasoning contained in the Australian decision **Perini v Commonwealth** [1969] 2 NSW 530. In that case, it was held that the employer was liable for the failure of the certifier to perform those duties properly. The certifier was an in-house person but that makes no difference in principle.

The reasoning of the Singapore Court of Appeal was that when an architect certifies, the architect is exercising a professional skill, opinion and judgment and must act fairly, impartially and independently. In so doing, the architect cannot be the agent of the building owner, because such impartiality is irreconcilable with the primary duty of agents to protect the interests of their principal. Therefore, building owners do not undertake or guarantee that the architect will exercise those powers reasonably.

In my respectful opinion, the well entrenched English law is to be preferred.

## **7. Constraints on the Activities of Design Consultants and Certifiers Through Attempted Cost Savings**

Some developers seem to think that if they do not ensure the provision of adequate certification functions (by a suitable person) during the period of the building project, or pay fees sufficient to ensure that there is proper certification, then somehow at the end of the day they will be able to fudge the position and the potential problem will go away. That is ridiculous. It never does. The certifiers need to be identified at the outset, be employed under terms of reference which will satisfy all of the third parties with an interest in the project, and be paid appropriately. Consultants who have a certifying role must stand up to any pressures which run contrary to such a necessary approach.

Consultants must be properly paid for their design, supervision, and certification obligations. If they are simply driven into the ground in relation to their fees or the time which can be spent then, of course, there will be problems. Of course, things will not be done properly. Of course, there will be deficiencies in the work.

One of the many things which puzzles me about the terms of engagement of, particularly, architects, is that they draw a distinction between simple observation and a more thorough form of inspection. Yet, if the architect is going to be relied on later to certify practical completion, it is difficult to see how an architect can properly do that unless he or she has provided more than mere observation during the progress of the work. Perhaps the problem is with my lack of understanding of what these terms mean but I can say that in a number of arbitrations the problem is a real one. The architect has been paid to “observe” but at the end of the job has simply issued a certificate of practical completion on a wing and a prayer because the previous observation has really not been enough to justify the issuing of the certificate.

Certifiers (whether salaried in-house staff of the employer or not) must stand firm and act objectively and independently. Unquestionably, the vast majority of certifiers set out to do their work fairly and conscientiously. But it is very difficult for them to do this if they are pressured by an unscrupulous employer, especially if they have been silly enough to take on the job for an uneconomic fee.

## **8. Inadequate Supervision – Poor Quality Work**

While a poorly supervised contractor cannot escape liability through lack of adequate supervision, it is quite inappropriate for an employer/developer to rely on that strict position. Yet it is surprising how often the developer will give a contractor a free hand and then complain at the very end of the job when there is a disproportionate amount of remedial work to do. This is an example of false economy at its worst, yet it is such a common occurrence. Of course, a contractor is obliged to work in a workmanlike manner. But anyone involved with the building industry will know that even the most conscientious and professional contractor will have lapses within their internal supervisory forces and it is simply false economy to think one can pick everything up at the end of the job. Proper regular independent supervision is essential and, at the end of the day, by far the cheapest option.

### **About the author**

*The observations in this paper are the result of 35 years’ experience advising employers or contractors on a large range of civil engineering and building projects in well over a dozen countries. Over the years these have included a power station and subsequent extension to it in Indonesia, offshore drilling programmes in the Pacific and South China Sea, as well as many more traditional construction projects. For many of those projects (including 12 hotels in New Zealand in the last five years) the author has been responsible for or involved in the preparation of the original tender documentation. In that 35 year period there would be well over 100 projects (some of them quite large) for which the author had responsibility for the conditions of contract.*

*In not one of those projects has any dispute ever proceeded to arbitration.*

*For the 12 year period 1983 – 1995 he was head of the construction and energy law team at Simpson Grierson.*