Contracts Law Conference

Allocating and managing the risk of the unexpected

By Nathan Abbott

This paper was presented at the LegalWise Contracts Law Conference in Melbourne in March 2013.

1. Introduction

The purpose of this paper and presentation is to examine the operation of a force majeure regime in the context of a typical contractual risk allocation and against the backdrop of the common law doctrine of frustration, as varied by statute.

Force majeure arises relatively rarely, however is topical, for example as a result of the impact of floods over the last couple of years on open-cut coal mining and rail transportation in Queensland, earthquakes in Christchurch and the Varanus Island explosion in 2008, which disrupted gas supplies in Western Australia to the extent of approximately 35% for two months.

It will always be best practice to try to identify, assess and allocate the risks of any transaction to the maximum extent possible. However, it will never be possible to anticipate every eventuality. The extent to which it is possible to do so will be a product of a range of factors, including particularly: the type and nature of the transaction; the parties' familiarity and experience with such transactions; and the expertise and effort brought to bear by the parties' advisers in negotiating and drafting the contract.

Contractual risk allocation can be conceived of for present purposes as a spectrum. At the far end of the spectrum is frustration, which operates to bring the contract to an end in the event of relatively extreme occurrences. Somewhere closer to the near end of the spectrum will be found a typical contractual risk allocation, with its precise location depending on the factors referred to above. In between the contractual risk allocation and frustration, is that part of the spectrum where a force majeure regime may operate to preserve the contract, despite some extreme occurrence, by suspending the obligations of the parties for the time being. The more thorough the contractual risk allocation, the closer it is to frustration on the spectrum and the less scope there is for the operation of a force majeure regime.

We will consider the law of frustration and some examples of a typical contractual risk allocation and a force majeure regime. A force majeure regime should always take account

of a number of key parameters and attention must always be paid to the risk that it may undermine the contractual risk allocation to the advantage of one party over the other.

2. Risk Allocation

As a construction lawyer, I would like to think that the standard form construction contracts are a useful basic template for good risk allocation practice. Construction projects, and the construction contracts which regulate them, are principally focussed on time, cost and quality, in particular which party will bear the risk of the unexpected with respect to the various factors which have been shown over the ages to have the potential to impact adversely on construction projects. Generally speaking, it will be the party best able to control or transfer the risk that should bear the risk, although risks beyond the control of either party will often also be allocated to one of them.

Both construction projects and construction contracts range in sophistication from the generic to the unique and bespoke. Construction contracts are often based on standard forms, however they are often very substantially amended. Not all of the risks apprehended by a construction contract will be relevant to other types of projects or transactions, however many will be, or will at least be analogous to relevant risks, essentially because the need to manage time, cost and quality is likely to be at the heart of any project or transaction.

By way of example, the AS 4300-1995 Australian Standard General conditions of contract for design and construct include at least the following clauses which allocate the risk of the unexpected:

2.1 Clause 12 – Latent Conditions

The latent conditions regime in AS 4300-1995 essentially provides for time and money to be adjusted in the contractor's favour where the physical conditions on the site differ materially from what should reasonably have been anticipated by the contractor.

2.2 Clause 14 – Legislative Requirements

Essentially, where a change in a legislative requirement could not reasonably have been anticipated and necessitates an impact on the contractor's cost, then the difference in cost is valued as a variation.

2.3 Clause 16 – Care of the Work and Reinstatement of Damage

The contractor is essentially responsible to care for the site and to reinstate it at the contractor's cost if it is damaged, unless the damage is caused by or on behalf of the

principal or is caused by one of the specific listed risks, essentially of a type not usually insurable.

2.4 Clause 35.5 – Extension of Time for Practical Completion

The contractor is essentially entitled to an extension of time, and therefore relief against liquidated damages for late completion, if there is a delay caused by:

(a) any of the following —

(i) industrial conditions;

(ii) inclement weather; or

(iii) any other cause,

occurring on or before the Date for Practical Completion and which are beyond the reasonable control of the Contractor; and

(b) any of the following other causes whether occurring before, on or after the Date for Practical Completion—

(i) delay or disruption caused by —

(A) the Principal;

(B) the Superintendent;

(C) an employee, consultant, other contractor or agent of the Principal or Superintendent;

(ii) actual quantities of work being greater than the quantities in a Schedule of Rates determined by reference to the upper limit of accuracy applicable to Clause 3.3(b) and stated in Annexure Part A (otherwise than by reason of a variation);

(iii) a Latent Condition;

(iv) a variation;

(v) a change in Legislative Requirements;

(vi) a direction by a municipal, public or statutory authority but not where the direction arose from the failure of the Contractor to comply with a Legislative Requirement;

(vii) delay by a municipal, public or statutory authority not caused by the Contractor;

(viii) a claim referred to in Clause 17.1(iv);

(ix) a breach of the Contract by the Principal; and

(x) another cause which is expressly stated in the Contract to be a cause for an extension of time for Practical Completion.

2.5 Clause 36 – Delay or Disruption Costs

Where the contractor has been granted an extension of time under clause 35.5(b)(i), that is caused by the principal, then the contractor shall be entitled to such extra costs as are necessarily incurred by reason of the delay.

2.6 Clause 37 – Defect Liability

During the defects liability period, which is typically 12 months for a commercial construction project, the contractor shall rectify defects and others may be engaged at the contractor's expense if the contractor fails to rectify defects when directed.

2.7 Clause 40 – Variations

The variations regime essentially provides for time and money to be adjusted in the contractor's favour where the contractor is directed to change what was to be constructed.

For any substantial commercial construction contract, these examples will be included, however they will typically be the subject of much negotiation and will be developed and refined in great detail.

Finally, it is noteworthy that the standard form contract does not include a force majeure regime but does include a clause providing for an entitlement to be paid if the contract is frustrated.

3. Frustration

No matter the extent to which the contractual risk allocation is developed and refined, there will be a point beyond which an extreme occurrence has the potential to make the performance of the contract pointless or impossible.

3.1 Common law doctrine of frustration

The test for frustration was formulated in England by Lord Radcliffe in *Davis Contractors*,[1] and adopted in Australia by the High Court in the case of *Codelfa Construction*,[2] as follows:

> "…frustration occurs whenever the law recognises that without default of either party a contractual obligation has become incapable of being performed because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract… It was not this that I promised to do."

Some illustrations of situations which the common law has recognised as constituting frustration are as follows:

(a) destruction of subject matter – for example, the case of *Taylor v Caldwell*,[3] where a contract for performances was frustrated by the burning down of the concert hall;

(b) disappearance of the purpose of the contract – for example, the case of *Herne Bay Steamboat Co*,[4] where a contract for boat hire to watch the coronation of the king was frustrated because the king had appendicitis and the coronation was cancelled;

(c) disappearance of, or radical change in, a state of affairs essential to performance – for example, the case of *Codelfa Construction*[5] mentioned above, where injunctions obtained by neighbours to stop railway construction works from being carried out at night, frustrated the construction contract;

---

[1] *Davis Contractors Ltd v Fareham Urban District Council* [1956] AC 696; [1956] 2 All ER 145.

[2] *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337 at 365; 41 ALR 367; per Mason J.

[3] *Taylor v Caldwell* (1863) 3 B & S 826; 122 ER 309.

[4] *Herne Bay Steamboat Co v Hutton* [1903] 2 KB 683.

[5] *Codelfa Construction Pty Ltd v State Rail Authority of New South Wales* (1982) 149 CLR 337; 41 ALR 367.

(d) the contract becomes illegal – for example, the case of *Denny Mott*,[6] where a contract for the supply of timber and lease of a timber yard was frustrated by new government regulations restricting such activities; and

(e) delay, although there is a high threshold for frustration in this instance, and there is difficulty in assessing how long a delay needs to be to frustrate a contract – for example:

(i) in the case of *Bank Line*,[7] a 12 month vessel charter contract was frustrated when the government requisitioned the ship for WWI for an indeterminate period; and

(ii) in the case of *National Carriers*,[8] a warehouse lease was **not** frustrated in circumstances where a road closure prevented access to the warehouse for 20 months of a 10 year contract.

The doctrine has also developed to recognise situations where frustration does not occur. For example:

(f) a contract is not frustrated simply because it has become uneconomical for one party;[9]

(g) a contract is not frustrated where the relevant supervening event was foreseeable – for example, the case of o*OH! Media Roadside*,[10] where a contract for use of a building to display outdoor promotional material was held not to be frustrated after the line of sight of approaching traffic was partially obstructed by a newly built office tower. In this case, it was acknowledged by the court that there is a difficulty in assessing the degree or extent to which an event must overturn expectations, or affect the foundation upon which the parties contracted, before the contract is taken to be frustrated;[11] and

---

[6] *Denny, Mott & Dickson Ltd v James B Fraser & Co Ltd* [1944] AC 265; [1944] 1 All ER 678.

[7] *Bank Line Ltd v Arthur Capel & Co* [1919] AC 435.

[8] *National Carriers Ltd v Panalpina (Northern) Ltd* [1981] AC 675; [1981] ANZ ConvR 73; [1981] 1 All ER 161; [1981] 2 WLR 45.

[9] *Maori Trustee v Prentice* [1992] 3 NZLR 344.

[10] *oOH! Media Roadside Pty Ltd v Diamond Wheels Pty Ltd* (2011) 32 VR 255; [2011] VSCA 116.

[11] *Ibid* at [66].

(h) a contract is not frustrated where the reason for the impossibility of performance is:

(i) a breach of the contract by one of the parties;[12] or even

(ii) self-induced – a state of affairs brought about by a party's own deliberate actions[13] (and potentially also a party's negligent actions).

It is evident from the above that to rely upon the common law to determine how and when a contract is frustrated would be to subject parties to a relatively opaque body of law, the consequences of which are likely to be difficult to predict in any given fact scenario. Its operation should ideally be the reserved for truly unexpected events, and to the extent that it is practical to do so, parties should specify in the contract how they intend to deal with those events which are able to be anticipated.

The consequences of frustration at common law are that parties are automatically released from their obligations and the losses are deemed to lie where they fall,[14] regardless of whether it is a reasonable outcome in the circumstances. This position has been modified by statute.

3.2 Statutory regime

In Victoria, frustrated contracts are now dealt with under Part 3.2 of the *Australian Consumer Law and Fair Trading Act 2012 (Vic)* (**Act**). The predecessor of this part was Part 2C of the *Fair Trading Act 1999 (Vic)*.

This part of the Act is broad in its application. It applies to a contract if the parties to the contract are discharged from the further performance of the contract because —

(a) performance of the contract becomes impossible; or

(b) the contract is otherwise frustrated; or

(c) the contract is avoided by the operation of section 12 of the *Goods Act 1958 (Vic)* (which states that where there is an agreement to sell specific goods, and subsequently the goods, without any fault on the part of the seller or buyer, perish before the risk passes to the buyer, the agreement is thereby avoided).

---

[12] *Heytesbury Properties Pty Ltd v City of Subiaco* (2000) 108 LGERA 259; [2000] WASC 8.

[13] *Scanlan's New Neon Ltd v Tooheys Ltd* (1943) 67 CLR 169; 43 SR (NSW) 153; [1943] VLR 72; (1943) 60 WN (NSW) 87.

[14] *Fibrosa Spolka Akcyjna v Fairbairn Lawson Combe Barbour Ltd* [1943] AC 32; [1942] 2 All ER 122.

There are exceptions to which the Act does not apply, but these are narrow categories, being insurance contracts (which are governed by their own separate legislation in the *Insurance Contracts Act 1984 (Cth)*), and certain contracts for ship hire or carriage of goods by sea.

It is also possible for parties to exclude the operation of the legislation by contracting to do so.[15] It is a question of construction whether the parties intended to exclude the operation of the legislation.[16]

3.3 Effects of the statutory regime

The key effects of the legislation are that:

(a) the common law position, that parties are discharged from their obligations, is confirmed – all amounts paid to any party before the time of discharge are recoverable, and all amounts payable before the time of discharge cease to be payable;[17]

(b) the court may exercise discretion to allow retention or recovery of amounts paid or payable under the contract, if it is just in the circumstances of the case;[18]

(c) if a party has obtained a valuable benefit because of anything done by another party in or for the purpose of the performance of the contract, the benefited party is liable to pay to the other party any amount (not exceeding the value of the benefit obtained) that the court considers just in the circumstances of the case;[19]

(d) contract provisions which are intended to still have effect despite frustration will still have such effect;[20] and

(e) a performed part of the contract is treated as if it were a separate contract that had not been frustrated or avoided, and is severed from the frustrated remainder of the contract.[21]

---

[15] Section 41 of the Act.

[16] *BP Exploration Co (Libya) Ltd v Hunt (No 2)* [1983] 2 AC 352; [1982] 1 All ER 925; [1982] 2 WLR 253.

[17] Section 36 of the Act.

[18] Section 37 of the Act.

[19] Section 38 of the Act.

[20] Section 41 of the Act.

[21] Section 42 of the Act.

Whilst these provisions may appear to establish a flexible and reasonable framework for dealing with the consequences of a frustrated contract, the practical application of this framework can be a difficult exercise to carry out. For example, consider the complexities that can arise from determining the meaning of the phrase "value of the benefit obtained" referred to in paragraph (c) above, or from determining what falls within a "performed" part of a contract referred to in paragraph (e) above.

3.4 Equity

Equity also has the potential to play a part in the resolution of questions as to liability in the event of the unexpected, arising from the conduct of the parties when confronted by the unexpected.

A leading authority on estoppel, *Waltons Stores*,[22] tells us that "to establish an equitable estoppel the plaintiff must prove that:

(a) the plaintiff assumed or expected that a particular legal relationship exists between the plaintiff and the defendant or that a particular legal relationship will exist between them and, in the latter case, that the defendant is not free to withdraw from the expected legal relationship;

(b) the defendant has induced (either actively or by a failure to deny the correctness of the expectation or assumption relied on by the plaintiff knowing that detriment will be caused to the plaintiff if the expectation or assumption is not fulfilled) the plaintiff to adopt that assumption or expectation;

(c) the plaintiff acts or abstains from acting in reliance on the assumption or expectation;

(d) the defendant knew or intended him to do so;

(e) the plaintiff's action or inaction will occasion detriment if the assumption or expectation is not fulfilled; and

(f) the defendant has failed to act to avoid the detriment whether by fulfilling the assumption or expectation or otherwise."

Equitable estoppel is an intricate area of law, and the application of the above elements can be a complex exercise.

---

[22] *Waltons Stores (Interstate) Ltd v Maher* (1988) 164 CLR 387 per Brennan J.

However, it is sufficient for our purposes to identify that the basic chain of events central to an equitable estoppel claim – inducement, reliance and detriment – can easily arise where circumstances have taken an unexpected turn.

Example case – *Update Constructions*

By way of illustration, take the case of *Update Constructions*.[23] A building contract for construction of child care premises was entered into for a fixed sum. With no apparent fault on the part of either party, it was discovered during the course of building that the proposed building was located on the site of an old well which had been built just under ground level. The result was the necessity to perform additional structural works, including to dig out new footings and to add further foundations, amongst other work.

The builder notified the proprietor's architectural agent of the situation in a conversation on the building site, and the agent agreed that the extra works should be carried out. Neither written notice nor written approval was given.

The contract was not crystal clear on how the situation was to be dealt with, but it did set out requirements:

- that, if the builder discovered any unexpected sub-surface conditions, the builder must notify the proprietor and obtain the proprietor's instructions before proceeding; and

- that the builder give written notice to the proprietor of any variation to the building works.

However, the clauses both contained references to a part of the contract which had been deleted, complicating the interpretation of the contract.

Leaving aside any questions of contractual interpretation, a key part of the case was that the NSW Supreme Court of Appeal found that the proprietor was estopped from later being allowed to rely upon a requirement for written notice as an answer to the builder's claim for reimbursement of costs incurred in carrying out the additional work. This was a result of the architectural agent's acquiescence to the builder's verbal proposal to carry out the works. The builder's action was a detriment to the builder, directly induced by the conduct of the architectural agent by representing (even if indirectly) that the requirement of written notice was not being insisted on.

---

[23] *Update Constructions Pty Ltd v Rozelle Child Care Centre Ltd* (1990) 20 NSWLR 251.

4. Force Majeure

A force majeure regime addresses the gap between the contractual risk allocation, which can never anticipate every eventuality, and the law of frustration. It operates to preserve the contract, despite some extreme occurrence, but it does so by suspending the obligations of the parties for the time being. It therefore has the potential to impact radically on the contractual risk allocation.

An excellent and instructive example of a force majeure regime is to be found in the Fédération Internationale Des Ingénieurs-Conseils (FIDIC, French for the International Federation of Consulting Engineers) Conditions of Contract for Construction 1999 (Red Book) at Clause 19, which provides as follows:

19. Force Majeure

19.1 Definition of Force Majeure

In this Clause, "Force Majeure" means an exceptional event or circumstance:

(a) which is beyond a Party's control;

(b) which such Party could not reasonably have provided against before entering into the Contract;

(c) which, having arisen, such Party could not reasonably have avoided or overcome; and

(d) which is not substantially attributable to the other Party.

Force Majeure may include, but is not limited to, exceptional events or circumstances of the kind listed below, so long as conditions (a) to (d) above are satisfied:

(i) war, hostilities (whether war be declared or not), invasion, act of foreign enemies;

(ii) rebellion, terrorism, revolution, insurrection, military or usurped power, or civil war;

(iii) riot, commotion, disorder, strike or lockout by persons other than the Contractor's Personnel and other employees of the Contractor and Sub- contractors;

(iv) munitions of war, explosive materials, ionising radiation or contamination by radio-activity, except as may be attributable to the Contractor's use of such munitions, explosives, radiation or radio-activity; and

(v) natural catastrophes such as earthquake, hurricane, typhoon or volcanic activity.

19.2 Notice of Force Majeure

If a Party is or will be prevented from performing any of its obligations under the Contract by Force Majeure, then it shall give notice to the other Party of the event or circumstances constituting the Force Majeure and shall specify the obligations, the performance of which is or will be prevented. The notice shall be given within 14 days after the Party became aware, (or should have become aware), of the relevant event or circumstance constituting Force Majeure.

The Party shall having given notice, be excused performance of such obligations for so long as such Force Majeure prevents it from performing them.

Notwithstanding any other provision of this Clause, Force Majeure shall not apply to obligations of either Party to make payments to the other Party under the Contract.

19.3 Duty to Minimise Delay

Each Party shall at all times use all reasonable endeavours to minimise any delay in the performance of the Contract as a result of Force Majeure.

A Party shall give notice to the other Party when it ceases to be affected by the Force Majeure.

19.4 Consequences of Force Majeure

If the Contractor is prevented from performing any of his obligations under the Contract by Force Majeure of which notice has been given under Sub-Clause 19.2 *[Notice of Force Majeure]* and suffers delay and/or incurs Cost by reason of such Force Majeure, the Contractor shall be entitled subject to Sub-Clause 20.1 *[Contractor's Claims]* to:

(a) an extension of time for any such delay, if completion is or will be delayed, under Sub-Clause 8.4 *[Extension of Time for Completion];* and

(b) if the event or circumstance is of the kind described in sub-paragraphs (i) to (iv) of Sub-Clause 19.1 *[Definition of Force Majeure]* and, in the case of sub-paragraphs (ii) to (iv), occurs in the Country, payment of any such Cost.

After receiving this notice, the Engineer shall proceed in accordance with Sub- Clause 3.5 *[Determinations]* to agree or determine these matters.

19.5 Force Majeure Affecting Subcontractor

If any Subcontractor is entitled under any contract or agreement relating to the Works to relief from force majeure on terms additional to or broader than those specified in this Clause, such additional or broader force majeure events or circumstances shall not excuse the Contractor's non-performance or entitle him to relief under this Clause.

19.6 Optional Termination, Payment and Release

If the execution of substantially all the Works in progress is prevented for a continuous period of 84 days by reason of Force Majeure of which notice has been given under Sub-Clause 19.2 *[Notice of Force Majeure],* or for multiple periods which total more than 140 days due to the same notified Force Majeure, then either Party may give to the other Party a notice of termination of the Contract. In this event, the termination shall take effect 7 days after the notice is given, and the Contractor shall proceed in accordance with Sub-Clause 16.3 *[Cessation of Work and Removal of Contractor's Equipment].*

Upon such termination, the Engineer shall determine the value of the work done and issue a Payment Certificate which shall include:

(a) the amounts payable for any work carried out for which a price is stated in the Contract;

(b) the Cost of Plant and Materials ordered for the Works which have been delivered to the Contractor, or of which the Contractor is liable to accept delivery: this Plant and Materials shall become the property of (and be at the risk of) the Employer when paid for by the Employer, and the Contractor shall place the same at the Employer's disposal;

(c) any other Cost or liability which in the circumstances was reasonably incurred by the Contractor in the expectation of completing the Works;

(d) the Cost of removal of Temporary Works and Contractor's Equipment from the Site and the return of these items to the Contractor's works in his country (or any other destination at no greater cost); and

(e) the Cost of repatriation of the Contractor's staff and labour employed wholly in connection with the Works at the date of termination.

19.7 Release from Performance under the Law

Notwithstanding any other provision of this Clause, if any event or circumstance outside the control of the Parties (including, but not limited to Force Majeure) arises which makes it impossible or unlawful for either or both Parties to fulfil its or their contractual obligations or which, under the law governing the Contract, entitles the Parties to be released from further performance of the Contract, then upon notice by either Party to the other Party of such event or circumstance:

(a) the Parties shall be discharged from further performance, without prejudice to the rights of either Party in respect of any previous breach of the Contract; and

(b) the sum payable by the Employer to the Contractor shall be the same as would have been payable under Sub-Clause 19.6 [Optional Termination, Payment and Release] if the Contract had been terminated under Sub-Clause 19.6.

And so, we can see there are various aspects and levels to the operation of the force majeure regime, including at least as follows:

4.1 Probability

There is an over-arching requirement above that the event must be "exceptional". Other examples of criteria expressed from time to time include: chance; extraordinary; and act of God. Ideally, the requisite probability will be quantified in some way by reference to objective criteria describing the extent of the event or its impact, for example by reference to data published by the Bureau of Meteorology or by reference to the extent of the disruption to the project or transaction.

4.2 Control

The requirement above is that the event must be beyond a party's control. Sometimes this requirement is qualified, for example by referring to reasonable control or being substantially beyond a party's control.

4.3 Mitigation

The requirement above is that the event could not have been provided against or reasonably avoided or overcome. There is also a duty in Clause 19.3 to use all reasonable endeavours to minimise any delay.

4.4 Exclusions

The definition above excludes events substantially attributable to the party. Other examples of common exclusions are: negligence; malfeasance; fault; and failure to exercise due diligence. There is also an exclusion in Clause 19.5 for situations where a subcontractor may have a greater entitlement to relief.

4.5 Impact

The requirement above is that performance be prevented. Other examples of common impacts include that performance be hindered or delayed, to some or any degree.

4.6 Qualification by degree

Each of the above aspects is liable to be qualified by reference to some degree, for example including: reasonableness; materiality; and substantiality.

4.7 Examples

The specific examples of events included above are typical, namely: war; rebellion; riot; radio-activity and natural disasters.

4.8 Notice

Notice is a typical requirement and strict compliance with any notice requirement may be a condition of any entitlement to relief.

4.9 Operation

The regime above operates in Clause 19.3 to excuse performance, except an obligation to pay, for so long as the event prevents performance.

4.10 Termination

Clause 19.6 above provides either party with a termination option if substantially all the work is prevented for a sufficiently long continuous or aggregated period. It also sets forth a formula to calculate the final financial reconciliation of the contract if it is so terminated, consistently with the usual contractual or statutory entitlement on frustration.

4.11 Frustration

Clause 19.7 above confirms that the force majeure termination payment entitlement will also apply if the contract becomes impossible or unlawful to perform or is otherwise frustrated under the law of the contract.

5. Conclusion

And so we can see that the capacity of a contract to accommodate the unexpected is the product of a range of factors, including particularly: the type and nature of the transaction; the parties' familiarity and experience with such transactions; and the expertise and effort brought to bear by the parties' advisers in negotiating and drafting the contract.

By thoroughly apprehending, assessing and allocating risks in the first place, reliance on a force majeure regime to guard against frustration, will be reduced.

A thoroughly drafted force majeure regime will then better respond to the inevitable residual risk of those events which can never reasonably be anticipated, without relieving a party from a risk properly allocated to it.