Drafting tips to achieve desired contractual risk allocation

Introduction

This paper considers the following issues, each of considerable importance for those involved in the drafting of construction and related contracts and each, recently, the subject of judicial consideration and a degree of controversy:

- The national proportionate liability scheme: can one contract out of proportionate liability? *Aquagenics Pty Limited v Break O'Day Council* [2010] TASFC 3.

  Some of the States allow parties to contract out of the national proportionate liability scheme. Short of a clear and unambiguous statement, what do the parties have to record in their agreements to effect such an outcome? The national proportionate liability scheme has been the subject of extensive commentary but not much judicial analysis, particularly at appellate level. A key Tasmanian decision has recently considered the "contracting out" provision. The case of *Aquagenics Pty Limited v Break O'Day Council*[1] is discussed below, together with some of the more fundamental issues to be considered when advising clients on "opting out".

- Recent legal developments and drafting tips to address liability for consequential loss in light of *Environmental Systems Pty Limited v Peerless Holdings Pty Limited* [2008] VSCA 26; and *Allianz v Waterbrook* [2009] NSWCA 224.

  Would a clause purporting to exclude 'consequential loss' achieve its purpose? The 2008 decision of the Victorian Court of Appeal in *Environmental Systems Pty Limited v Peerless Holdings Pty Limited*[2] reopened the debate about how Australian courts are likely to construe 'consequential loss' clauses in commercial contracts. The decision casts considerable doubt upon the meaning of the expression once many would have considered and still consider settled. This paper considers the approach adopted in *Peerless* and the conventional wisdom embodied in the rule in *Hadley v Baxendal*[3]*e*, in an attempt to identify a path of greater certainty for contract drafters.

- Drafting indemnities to achieve desired risk allocation.

  The principles applying to construing the meaning of words and expressions in contracts so prominent in *Peerless* also feature in decisions made by the courts recently upon the efficacy and scope of indemnity clauses.

Courts appear to be been sending mixed messages about the manner in which they will construe the intention of contracting parties when asked to determine the meaning of words and expressions in contracts. From the point of view of a drafter, the challenge is to draft provisions that will survive such interpretation with the true intention of the parties intact.

1 [2010] TASFC 3.
2 [2008] VSCA 26.
3 (1854) 9 Ex 341; 156 ER 145

Prevailing theory of constructing exclusion/limitation clauses

Overview

Since this paper is concerned with drafting clauses that limit the operation of certain aspects of the law upon bargains struck by contracting parties, it would be instructive, before embarking on this exercise, to consider briefly the prevailing theory that ought to guide our courts in the interpretation of such clauses.

In an address to business in 2007, Chief Justice Spigelman said:[4]

> A principal purpose of the detail found in commercial agreements, as well as a significant purpose of contract law, is to allocate risk between the parties, often enough with respect to contingencies that cannot be anticipated. Interpretation is the necessary means of determining how those risks were in fact allocated. Anything which increases the level of uncertainty about how words have performed that task, itself increases risk. There is a certain cannibalistic quality about that proposition, but I think I will keep it.

The subject of his Honour's address was the "paradigm shift" during the course of the last few decades towards applying a purposive, contextual approach to the interpretation of contracts and statutes – 'in contractual discourse, the focus on the commercial purposes of a transaction is often referred to as commercial interpretation or commercial construction'. His Honour highlighted as a "significant concern" the issue of whether this shift 'has undermined the desirable objective of ensuring commercial certainty'.[5]

The general approach to the construction

In the context of contract law, it is generally accepted that the prevailing approach to construction of exclusions and terms was expounded by the High Court in *Darlington Futures Limited v Delco Australia Pty Limited*[6]. In that case the High Court expressed the rule as follows:[7]

> The interpretation of an exclusion clause is to be determined by construing the clause according to its natural and ordinary meaning, read in the light of the contract as a whole, thereby giving due weight to the context in which the clause appears including the nature and object of the contract, and, where appropriate, construing the clause contra proferentem in the case of ambiguity. (emphasis added)

In *Project Blue Sky Limited v Australian Broadcasting Corporation*[8] the Court stated in the context of statutory construction:[9]

> Ordinarily, [the legal meaning] will correspond with the grammatical meaning of the provision. But, not always. The context of the words, the consequences of a literal or grammatical construction, the purpose of the statute or the canons of construction may

4 Chief Justice Spigelman, 'From Text to Context - Contemporary Contractual Interpretation' (Speech delivered at the Risky Business Conference, Sydney, 21 March 2007).
5 Ibid.
6 (1986) 161 CLR 500.
7 Ibid at [510] per Mason, Wilson, Brennan, Deane and Dawson JJ. Their Honours go on to confirm that 'the same principle applies to the construction of limitation clauses'.
8 (1998) 194 CLR 355.
9 Ibid at [384] per McHugh, Gummow, Kirby and Hayne JJ.


> require the words of a legislative provision to be read in a way that does not correspond with the literal or grammatical meaning.

In *K & S Lake City Freighters Pty Limited v Gordon & Gotch Limited*[10] Mason J (as he then was) stated:[11]

> The modern approach to interpretation insists that the context be considered in the first instance, especially in the case of general words, and not merely at some later stage when ambiguity might be thought to arise …

In the context of indemnity clauses in a policy of insurance Gleeson CJ in *McCann v Switzerland Insurance*[12] expressed the rule in the following terms:

> A policy of insurance, even one required by statute, is a commercial contract and should be given a business like interpretation. Interpreting a commercial document requires attention to the language used by the parties, the commercial circumstances which the document addresses, and the objects which it is intended to secure.

Whilst these decisions appear to confirm that the contextual, commercial approach to the interpretation of commercial contracts has attained ascendancy in Australia, already one can see that the potential for significant differences in what would in a given situation constitute the "ordinary and natural" meaning of a word or expression. Indeed the ordinary and natural meaning of that expression itself is open for debate as the above extracts from three separate cases attest. Can one with meticulous care draft a clause in the hope that it would be given literal or grammatical effect without the intrusion of context that could obtain a consequence not intended by the drafters or the parties to the contract? Will such an approach always ascertain the "common intention" of the parties (which, we should remind ourselves is an objective and not a subjective forensic exercise) with the level of certainty that our Chief Justice indentifies as being so important to the commercial community in the management of risk?

Contracting out of the proportionate liability scheme

Overview

Each of the states and territories has enacted proportionate liability legislation, the focus of which is to regulate liability between:

- persons suffering economic loss or property damage and those responsible for causing such loss or damage (**wrongdoers**); and
- the wrongdoers themselves,

but only in circumstances where the claim:

- includes a claim for damages whether in contract, tort or otherwise(the action may include claims on other legal bases);
- arises from a failure to take reasonable care; and
- does not concern person injury.

10 K & S Lake City Freighters Pty Ltd v Gordon & Gotch Ltd (1985) 157 CLR 309.
11 Ibid at [315].
12 (2000) 203 CLR 579 at [22].

In New South Wales the scheme is introduced by Pt 4 of the *Civil Liability Act 2002* (**Act**).

The proportionate liability provisions under the Act came into force in 1 December 2004. Schedule 1 to the Act relevantly provides that they:

- extend to civil liability arising before September 2002; but
- do not apply to proceedings commenced in a court before that time.

The key effect of the legislation is to remove the old common law approach to liability of wrongdoers which enabled the party suffering loss or damage to claim 100% of that loss or damage from any of the wrongdoers concurrently liable to it. Under this regime, not surprisingly, the claim was often made against the party with the deepest pockets leaving the party with the deepest pockets to join others from whom it might be able to seek a contribution. Thus the 'deep-pocketed' party also carries the risk that one or more potential cross-defendants may be impecunious.

Under the legislation, wrongdoers are liable to the plaintiff proportionately to the extent of their contribution to the loss or damage suffered and, importantly, the plaintiff bears the:

- onus of joining all concurrent wrongdoers to any action in which it hopes to recover 100% of its loss or damage; and
- risk of non-recovery from wrongdoers who had since become insolvent or were not able to be located.

Whilst there is a considerable degree of commonality between the proportionate liability legislation of each jurisdiction, there are some notable differences. This paper will consider only the position in New South Wales and other states who have adopted the New South Wales formulation.

Important considerations for any one negotiating a contract are the operation of this legislation upon disputes arising under or in relation to such contracts. Relevantly, those questions are:

- Can parties contract out of the legislation?
- If so, how can "contracting out" can effected? and
- Is it always necessary to "contract out" of the legislation?

Can parties contract out of the legislation?

Section 3A of the Act provides:

> **3A Provisions relating to operation of Act**
>
> (1) A provision of this Act that gives protection from civil liability does not limit the protection from liability given by another provision of this Act or by another Act or law.
>
> (2) This Act (except Part 2) **does not prevent the parties to a contract from making express provision for their rights, obligations and liabilities under the contract with respect to any matter to which this Act applies and does not limit or otherwise affect the operation of any such express provision**.


(3) Subsection (2) extends to any provision of this Act even if the provision applies to liability in contract.
(emphasis added)

Provisions in identical terms exist in the *Civil Liability Act 2002* (Tasmania). The *Civil Liability Act 2002* (Western Australia) is in different terms but also permits contracting out. The relevant civil liability legislation in Victoria, the ACT and the Northern Territory do not address the issue of contracting out, whilst the *Civil Liability Act 2003* (Queensland) prohibits it.[13]

The Act clearly contemplates that parties in their agreements can control the way in which the Act would operate for them. The only guidance the Act gives to the parties as to how this can be effected is that they may do so in "a contract ... making express provision for ... rights, obligations and liabilities" (emphasis added).

How can the contracting out be effected?

The formulation in section 3A(2) makes it clear that only an express provision would be effective to modify the operation of the Act. In other words, the modification will not be implied.

As express instructions go, a provision to the following effect ought to be clear and unambiguous:

> *Civil Liability Act 2002*
>
> To the extent permitted by law the operation of Part 4 of the *Civil Liability Act 2002* (NSW) is excluded in relation to all and any rights, obligations and liabilities under the contract whether such rights, obligations or liabilities are sought to be enforced as a breach of contract or a claim in tort or otherwise.

Such a provision would, in the case of contracts governed by the law of New South Wales, constitute a valid 'contracting out' clause as the intent is not only express but clearly stated.

However, what of contracts which do not contain express reference to the Act? Can the parties' intentions as to the operation of the Act nonetheless be divined from the terms of the contract or would the failure to make express reference to the Act be fatal to any attempt to exclude the operation of the Act?

This is an issue which the Full Court of the Supreme Court of Tasmania considered in *Aquagenics*.

Relevantly, the "contracting out" section of the Tasmanian legislation is in identical terms to that of the Act and the deliberation of the Supreme Court of Tasmania may give some guidance to us in NSW.

The contract in that case contained the Australian Standard's general conditions for design and construct. The contract did not make express reference to the Act but contained in the following unamended provisions:

> *Clause 9.3*
>
> Approval to subcontract shall not relieve the Contractor from any liability or obligation under the Contract. Except where the contract otherwise provides, the Contractor shall

13 See subsection 7(3).


> be liable to the Principal for the acts and omissions of subcontractors and employees and agents of subcontractors as if they were acts or omissions of the Contractor.
>
> ...
>
> *Clause 44.10*
>
> If the Contract is terminated ... the rights and liabilities of the parties shall be the same as they would have been at common law had the defaulting party repudiated the Contract and the other party elected to treat the Contract as at an end and recover damages.

As the Standards Australia forms of contract are used widely, the deliberations of the Supreme Court of Tasmania have added value.

Evans J, with whom Wood J agreed, considered the meaning of the words 'express provision' in light of the remarks of Toohey, Gaudron and Gummow JJ in *Akai Pty Limited v People's Insurance Co Limited*[14] when determining the meaning of the phrase 'an express provision to the contrary included ... in the contract' from the *Insurance Contracts Act 1984* (Commonwealth). In that context, their Honours relevantly stated:[15]

> The words 'express provision' in that phrase embrace those provisions of the contract from which, or by recourse to which, it would be determined that the parties to the contract had selected or chosen a proper law which was not the law of a State or Territory.

Evans J expressed the opinion that such an approach applied in the present context and the terms of subsection 3A(3) of the Act did not require that a contract make a reference to the Act as a pre-condition to a finding that the parties intended to exclude its operation. Rather, consistently with the reasoning in *Akai*, it was sufficient for the contract to contain provisions from which it would be determined that the parties had that intention.[16]

In the case of *Aquagenics*, the presence of clauses 9.3 and 44.10 (extracted above), amongst others, made it tolerably clear to Evans J that 'the combined effect of the provisions ... is just as emphatic for the purposes of s3A(3)'[17] as a provision making a direct reference to the Act and, as a consequence, the contractual regime excluded the operation of the Act. His Honour believed that such a construction was also consistent with the commercial intention of the parties:[18]

> Consistent with principles of privity of contract, it is the Contractor to whom the Principal is entitled to look for a remedy referable to the contract. That this is so no doubt has a considerable bearing on the insurance, security and retention money provisions in the contract to which I have referred. From the standpoint of the Principal the utility of those provisions would be greatly diminished if the Contractor could limit its liability in respect of a claim made by the Principal, by identifying other concurrent wrongdoers.

His Honour then considered the effect of each of these key clauses in turn. In respect of clause 9.3, his Honour held that:[19]

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14 (1996) 188 CLR 418.
15 Ibid at 436.
16 Aquagenics at [14] to [17].
17 Ibid at [22]
18 Ibid at [20]
19 Ibid at [21].


> Whilst cl 9.3 is not expressed so widely to cover every conceivable entity that might be a concurrent wrongdoer, its intent is plain. That is, that the Contractor shall be liable to the Principal for the acts and omissions of subcontractors, which includes Consultants and employees and agents of the same.

In respect of clause 44.10 his Honour stated:[20]

> That a concurrent wrongdoer might emerge that is not a subcontractor or an employee or agent of a subcontractor, does not mean that the Contractor is entitled to have its liability to the Principal limited pursuant to Part 9A referable to that concurrent wrongdoer, as this would fly in the face of cl 44.10. The Contractor contends that it has validly terminated the contract pursuant to cl 44.9 and cl 44.10 expressly provides that in the event of such a termination the rights and liabilities of the parties shall be the same as they would have been at common law. This clause recognises that, save as otherwise provided in the contract, the parties' rights and liabilities shall be as they would be at common law. For Part 9A of the Act to apply so as to limit the Contractor's liabilities to the Principal in relation to that claim in the event that a concurrent wrongdoer not covered by clause 9.3 could be identified, would not accord with the parties' common law rights and liabilities.

The contract the subject of these proceedings was signed after the commencement of the proportionate liability provisions in the Tasmanian version of the Act. It was submitted in the course of argument that because the contract consisted of a standard form which preceded the commencement of the Act and had not been amended prior to execution - it could be inferred that, when signing the contract, the parties were not cognisant of the existence of the proportionate liability provisions and therefore could not have the requisite intention to contract out of them.

This view was not accepted by the Court. Although, by reason of the fact that the date on which the contract was executed was later than the date on which the legislative provisions came into effect, it was not necessary for the Court to decide whether a similarly drafted contract signed before the provisions came into effect could also be construed in a manner that ousted the operation of the Act. The better view is that, given the terms of section 3A(2), it is likely that a contract such as the one the subject of *Aquagenics*, would be construed as expressly ousting the operation of the Act even if it was signed before the proportionate liability provisions came into effect.

Although the judges come to the same conclusion (ie the contract excluded the operation of the Act) they followed slightly different routes. The majority view (Evans & Woods JJ) relied on both clauses 9.3 and 44.10 to extract the relevant intention. Tennent J on the other hand (together with the judge at first instance) appeared to be content with clause 9.3, even though that provision only operates with respect to a subset of potential "wrong doers" namely subcontractors, agents and the like to the contractor.

This reasoning suggests that it is not necessary for a contract to comprehensively exclude the operation of the Act. Partial conclusions may be enough to exclude the provisions completely for the purposes of the contract.

It is apparent from the foregoing that:

- a contract need not make express reference to the Act in order for it to be construed as ousting the operation of the proportionate liability provisions of the Act;

20 Ibid

- when construing contracts for this purpose, the courts will look at the whole of the contract to discern the intention of the parties.

Key issues relevant to the decision to contract out

A detailed examination of the advantages and disadvantages of participating in the proportionate liability scheme under the Act is beyond the scope of this paper. However, as a general guide, the following issues are likely to be of significance to the decision to contract out:

- Proportionate liability favours contractors and makes cost recovery by principals more difficult not only because it necessitates joining all potential wrongdoers to any proceedings, but also because the principal will bear the risk of any wrongdoer having insufficient funds to meet its proportionate liability. It is likely that the ultimate decision regarding the exclusion of the Act will come down to the relative commercial strength of the parties.
- Proportionate liability tends to offend against the key principle for the allocation of risk in construction contracts – namely, to the party or parties best able to manage it. By distributing liability proportionately across all wrongdoers and capping the liability of each wrongdoer to the extent of its responsibility, the legislation creates a default position that will not necessarily reflect the practical reality of any given construction contract.
- A subset of the second point is that principals in particular when contracting with a party often carry expectations that the party they have contracted with presents a "one-stop-shop" for responsibility for the service or work to be delivered. There is not usually the expectation that the principal would be pursuing an unknown class of defendants for a remedy in the event that the bargain fails.
- A common source of opposition to clauses excluding operation of the Act is the insurance industry. When confronted with such opposition during contract negotiation, a principal is faced with a choice of insisting on such a clause (and consequently with losing the contractor or a contractor facing increased premiums from its insurer or the possibility that the risk would be uninsured) or foregoing it. It seems, however, that even foregoing it would not assist the contractor because as *Aquagenics* shows, the Court may be prepared to look at the contract as a whole to the same effect. To overcome unintended exclusion of the operation of the Act (which *Aquagenics* appears to suggest that would occur automatically if one were to use a contract such as the popular Standards Australia forms), the parties would be best advised to make their intentions patent by inserting a clause as follows:

  "Notwithstanding anything to the contrary in the contract, the parties intend that the Act applies to any claims for damages arising from a failure to take reasonable care."
- A collateral effect of *Aquagenics* is the need for the parties to consider the efficacy of ADR clauses. The decision also concluded that the Act does not operate in the context of arbitrations (and by corollary in an expert determination or the like). If this view is correct, then where multiple defendants are likely and the Act operates, the inclusion of a such a compulsory arbitration or expert determination clause may have the unintended consequence of ousting it.

Update on consequential loss

Overview

The operation of the contextual approach to construction looms large in *Peerless*, in which the Court of Appeal of Victoria considered the efficacy of an express term in a contract (as it found) purporting to exclude consequential loss.

Since the middle part of the nineteenth century, conventional wisdom has dictated that losses arising from a breach of contract will only be recoverable if falling within either of the "two limbs" of the rule in *Hadley v Baxendale*, namely:

- Losses that may fairly and reasonably be considered as arising naturally, according to the usual course of things, from the breach itself; and
- Losses which may reasonably be supposed to have been in the contemplation of both parties at the time of executing the contract, as a probable result of the breach.

Losses falling outside either of the limbs were, as a general rule, considered too remote to be the subject of an award of damages for breach of contract.

Losses falling within the limbs of the rule in *Hadley v Baxendale* have been traditionally referred to in terms of "direct losses" and "indirect or consequential losses" respectively. Indeed this distinction prevails in the construction industry as repeated requests that "consequential losses" be excluded attests.

Today a term simply excluding "consequential losses" may have much broader and unanticipated consequences than the so-called traditional understanding would lead one to believe.

Peerless

The subject matter of the decision in *Peerless*, insofar as it relates to damages arising from breach of contract, was the performance by Environmental Systems Pty Limited (**Environmental Systems**) of a contract for the supply of a system to limit the odour emissions from an animal rendering plant operated by Peerless Holdings Pty Limited (**Peerless**).

The contract in question contained the following clause:

> As a matter of policy, Environmental Systems does not accept liquidated damages or consequential loss. Environmental Systems is motivated to achieving agreed milestones through respect for the client's needs and the obvious financial advantage gained from completion of projects in the shortest possible period.

Notwithstanding the idiosyncratic wording of the clause and the fact that the document elsewhere purported to impose liquidated damages, it was held to be a clause excluding consequential loss from any damages recoverable by Peerless in the event of a breach of contract by Environmental Systems.

The odour elimination system supplied by Environment Systems had comprehensively failed. In determining the damages that Peerless was entitled to recover for this failure, the Court


had to decide what nature of the losses were capable of being characterised as being "consequential" in nature and therefore excluded.

The heads of loss the subject of Peerless' claims fell generally within the following categories:

- Purchase, installation and commissioning costs of $1,272,520 (**Purchase Claim**);
- Employee and contractor costs involved in attempts to make the system functional of $223,560 (**Wasted Labour claim**);
- Costs involved in dismantling and disposing of the system of $34,000 (**Disposal Claim**); and
- Additional energy costs incurred as a consequence of the system not being functional of $1,712,419 (**Additional Gas Claim**).

At first instance, Hansen J held that the Purchase Claim and Wasted Labour Claim were claims for liquidated damages and were not recoverable by reason of the express wording of the exclusion clause. His Honour rejected the Disposal Claim on the basis that these costs would have been eventually incurred even if the system had functioned properly. His Honour allowed the Additional Gas Claim after deciding that it fell within the first limb of the rule in *Hadley v Baxendale* and was not a consequential loss. However, he subtracted from it the purchase and installation costs. In relation to this point, his Honour relevantly said:[21]

> That brings me to the matter of consequential loss. In my view "consequential" should be read as referring to losses recoverable only under the second limb of *Hadley v Baxendale*. And see *Frank Davies Pty Ltd v Container Haulage Group Pty Ltd (No 1)* and *BHP Petroleum Ltd v British Steel PLC* in the latter of which Rix J discussed a number of authorities as to the meaning of "consequential" and the determination in particular circumstances whether an item of loss was consequential. In my view the claim for additional energy costs is not a claim for consequential loss. The loss arises naturally and directly from the failure of the plaintiff to provide [a system] that could perform as intended under the terms of contract. It was a principal reason for the plaintiff agreeing to the defendant's proposal that the RTO would use less gas than the existing afterburner thus earning savings in the cost of gas. The defendant knew this and it was reflected in various provisions of the proposal, for example cll 1.2(a) and (d), 7.2 and 7.7.2.

On appeal Nettle JA, who delivered the opinion of the Court, rejected Hansen J's characterisation of the Purchase Claim as liquidated damages and excluded by the contract. However, his Honour found the proper approach to the question which, if any, of the claims fell within the exclusion of consequential loss was "a vexed one".

The Court of Appeal acknowledged that the view expressed by Hansen J accorded with the body of English authority (*Hadley v Baxendale*) as had been applied in Australia by judges at first instance. The Court of Appeal adopted the test expressed in *McGregor on Damages* (***McGregor* Test**) to express the difference between normal loss and consequential loss, namely:[22]

…the true distinction is between "normal loss", which is loss that every plaintiff in a like situation will suffer, and "consequential losses", which are beyond the normal measure, such

21 Peerless Holdings v Environmental Systems Pty Ltd [2006] VSC 194 at [896].
22 Peerless at [87].


as profits lost or expenses incurred through breach. In the view of Nettle JA (and the Court of Appeal), however, this dichotomy was not necessarily consistent with the application of the rule in *Hadley v Baxendale* because some "consequential loss" (in the *McGregor* Test) 'may well fall within the first rule in *Hadley v Baxendale* as loss arising "naturally", ie. according to the usual course of things, from the breach of contract'.[23] His Honour then cites at [88] a series of cases in the English Court of Appeal in which loss of profit and the like which one would in the traditional operation of that distinction consider to be "consequential loss" were held to be not consequential loss. These cases showed a readiness on the part of the English Court of Appeal to contemplate that "consequential losses" were not forever consigned to the second limb of *Hadley v Baxendale* but that they could well fall into the first limb.

The Court of Appeal concluded that it was 'not correct to construe "consequential loss" as limited to the second rule in *Hadley v Baxendale*.'[24] In the words of Nettle JA:

> In my view, ordinary reasonable business persons would naturally conceive of "consequential loss" in contract as everything beyond the normal measure of damages, such as profits lost or expenses incurred through breach. Despite the construction which has been put on "consequential loss" by cases such as *Millar* and *Croudace* [upon which the rule in *Hadley v Baxendale* is based], it would be unrealistic to suppose that the appellant and the respondent employed the expression "consequential loss" in [the contract] advisedly in that sense. It is more likely in this context that they intended the expression to have its ordinary and natural meaning…Read in the light of the contract as a whole, and giving due weight to the context in which the clause appears, including the nature and object of the contract, I see no ambiguity which as a matter of principle would warrant a departure from that view.

According the words in the exclusion clause their "natural and ordinary" meaning, as set out above, his Honour went on to find that the losses the subject of the Wasted Labour Claim and the Additional Gas Claim were in the nature of consequential losses and were therefore excluded under the relevant clause of the contract.

It is not coincidental that his Honour invokes the formula for construction established in *Darlington Futures Limited v Delco Australia Pty Limited.* Indeed at [92] his Honour cites the relevant passage from that case with approval.

There are a number of features about the *Peerless* case that may lead others to a different conclusion. Quite apart from the rather curious expression used in the limitation clause (namely, a statement of the "policy" of the company which is readily contradicted by express terms in the very same agreement to pay liquidated damages for specified events) the court was critical of the agreement as being:

> …a poorly drafted instrument. It bears the hallmarks of having being cobbled together from a combination of boiler plate clauses and bespoke provisions …[82]

If the true purpose of construction is to divine the intention of the contracting parties then can one comfortably ascribe natural and ordinary meanings flowing from a document having such a dubious genesis? Why wouldn't a relevant part of the "context" be the cut-and-paste way in which the contract was created?

23 Ibid at [88].
24 Ibid at [93].

Peerless in New South Wales

The reasoning of Nettle JA in *Peerless* has been viewed favourably in at least one instance in the Supreme Court of New South Wales.

In *Waterbrook at Yowie Bay Pty Limited v Allianz Australia Insurance Limited*,[25] McDougall J was required to consider the scope of an exclusion of consequential loss in a policy of insurance. His Honour, without displaying any of the vexation that had beset Nettle JA, addressed the issue with a degree of brevity, thus:[26]

> In [*Peerless*] Nettle JA … said at [88] that some "consequential loss" may well fall within the first limb of *Hadley v Baxendale* … On the authority of the decisions to which I have referred:
>
> The measure of damages is that laid down in *Bellgrove* (of course, with the limitation also there laid down);
>
> That measure reflects the first limb in *Hadley v Baxendale*;
>
> Those damages may include consequential loss…

On appeal, the Court of Appeal agreed with his Honour: *Allianz v Waterbrook* [2009] NSWCA 224 at [126].

However, it should be borne in mind that McDougall J (and the Court of Appeal) was considering four preliminary questions regarding entitlement to indemnity under the policy and whether certain of the policy's clauses were void in the face of statutory or public policy considerations. His Honour did not consider in detail the applicability of the clause excluding consequential loss to particular heads of claim. Further guidance on the issue has not been forthcoming from the High Court and it is not apparent that Nettle JA's decision was the subject of an application for leave to appeal.

Excluding "consequential loss"

Unfortunately, the decision in *Peerless* seems precisely to have resulted in the realisation of the situation envisaged by Spigelman CJ – an increase in uncertainty and an increase in risk which makes the task of those negotiating contracts harder. The consideration of issues of causation and deciding whether they arose "naturally, according to the usual course of things, from the breach itself" is far from being an exact science. There is nothing remarkable about the inherent imprecision of this approach and its propensity to lead to disparate findings, even in cases which involve similar facts – such is the nature of the judicial process.

Where lawyers are employed in the drafting and negotiation of commercial contracts it is likely that the parties would receive advice on that very point. Such advice would no doubt have been referable to the rule in *Hadley v Baxendale*.

From the foregoing, it ought to be apparent that the term "consequential loss" has lost any firm juridical foothold in Australia.

In these circumstances, it appears that the only approach that offers a degree of certainty and, accordingly, a reduced risk, is for parties to commercial contracts to specify those

25 [2008] NSWSC 1451
26 Ibid at [77] to [78].

heads of damage which are intended to be excluded from liability or, at the very least, those that are not.

Drafting indemnities to achieve desired risk allocation

Overview

An indemnity is essentially a promise by a party to hold the other harmless in respect of certain categories of loss or damage.

It is not uncommon for building contracts to be littered with indemnities often flowing in one direction only. Commonly, the party with the most commercial clout in respect of a project, particularly where the project is large or risky, will insist on indemnities from other participants, often drafted in the broadest possible terms.

The adoption of broad ranging indemnities is not always the best tool for achieving the commonly stated goal within the industry that risk in construction contracts should be apportioned to the party or parties best able to manage it.

The scope and operation of indemnity clauses frequently employed are often misunderstood by parties and their lawyers. They may not receive the application that a party may have expected when the term was negotiated. Applying the principles of construction discussed earlier in this paper, broadly drafted indemnities may ultimately be construed by the courts much more narrowly than the parties intended. This is best illustrated through the decision of the High Court in *Andar Transport Pty Limited v Brambles Limited*. [27]

Andar

In *Andar*, a contract between Brambles Limited (**Brambles**), a company providing laundry delivery services to hospitals, and an independent contractor, Andar Transport Pty Limited (**Andar Transport**) which carried out those services, contained an indemnity with the following relevant provisions:

> [Andar Transport] shall:
>
> ...
>
> 8.2 Indemnify [Brambles] from and against all actions, claims, demands, losses, damages, proceedings, compensation, costs, charges and expenses for which [Brambles] shall or may be or become liable whether during or after the currency of the Agreement and any variation renewal or extension in respect of or arising from -
>
> 8.2.1 loss, damage or injury from any cause to property or person occasioned or contributed to by the neglect of default of [Andar Transport] to fully, duly, punctually and properly pay, observe and perform the obligations,

27 (2004) 317 CLR 424.


> covenants, terms and conditions contained in the Agreement and on the part of [Andar Transport] to be paid, observed and performed.
>
> 8.2.2 loss, damage injury or accidental death from any cause to property or person caused or contributed to by the conduct of the Delivery Round by [Andar Transport];
>
> 8.2.3 loss, damage, injury or accidental death from any cause to property or person occasioned or contributed to by any act, omission, neglect or breach or default of [Andar Transport]...

Mr Wail, a director and shareholder of Andar Transport was injured during a delivery round when he was forced to separate two laundry trolleys (owned by Brambles) that had become joined. He sued Brambles for negligence based upon the lack of manoeuvrability of the trolleys, especially when full.

Was the clause sufficiently broad so as to extend to loss arising from Brambles own negligence? The clause itself made no express reference to this situation.

The Victorian Court of Appeal, applying the principles enunciated in *Darlington v Delco,* held that that 'on their plain and ordinary meaning', the provisions of the contract were sufficiently broad and did not exclude Brambles' own negligence.[28] The Court held that the effect of that clause was that Andar Transport was required to indemnify Brambles.

The High Court disagreed and overturned the decision.

Curiously, the majority decision makes no reference to *K & S Lake City Freighters*, *Darlington v Delco* or *McCann v Switzerland Insurance*. Instead, their Honours referred to more ancient authorities, including the decision of the Barons of the Exchequer in *Mayer v Isaac*.[29] This line culminated, in the Australian context, with *Ankar Pty Limited v National Westminster Finance (Australia) Limited*,[30] which concerned not a general commercial contract, but a suretyship contract in respect of which the Court considered special rules applied.

The majority in *Andar* (Gleeson CJ, McHugh, Gummow, Heydon and Hayne JJ) held that indemnity provisions (as opposed to other types of clauses that purport to limit or exclude liability) in commercial contracts ought to be treated in the same way as guarantees in suretyship contracts because **'**... notwithstanding the differences in the operation of guarantees and indemnities, both are designed to satisfy a liability owed by someone other than the guarantor or the indemnifier to a third person''.[31]

The majority decision quoted, with approval, the statement of the majority in *Ankar*, namely:[32]

> At law, as in equity, the traditional view is that the liability of the surety is strictissimi juris and that ambiguous contractual provisions should be construed in favour of the surety.

Their Honours invoked *Chan v Cresdon Pty Limited*[33] as authority for the proposition that this statement was a 'settled principle governing the interpretation of contracts of guarantee'

28 Brambles Limited v Wail (2002) 5 VR 169.
29 (1840) 6 M & W 605.
30 (1987) 162 CLR 549 at 557.
31 Andar (High Court) at 437.
32 Andar (High Court) at 433.
33 (1989) 168 CLR 242.


and that '[t]he principles adopted in *Ankar*, and applied in *Chan*, are therefore relevant to the construction of indemnity clauses'. [34]

Their Honours held, therefore, in the case of ambiguity, that the clause should be construed strictly, read *contra proferentem* and construed in favour of the surety.[35] As the clause did not expressly mention loss arising from Brambles' own negligence, therein arose the ambiguity. Construed against the *proferens* Brambles their Honours held that the indemnity did not extend to the injury caused to Mr Wail by Brambles' negligence.

In dissent, Callinan J confirmed his agreement with the Court of Appeal's approach to the construction of the indemnity clauses.[36] His Honour quoted, with approval, the decision of the High Court in *Darlington v Delco* and also in *McCann v Switzerland Insurance*, each of which, in his Honour's view, supported the proposition that no special rules of construction should applied to indemnities in commercial contracts.[37] Callinan J found in the indemnity clauses, 'the clearest possible intention on the part of the parties to ensure that [Brambles] is not to be liable for any loss arising out of the performance of the work by the appellant'.[38]

The majority decision in *Andar* is made all the more perplexing by the High Court's approach to the construction of indemnities, less than a year later, in *Pacific Carriers Limited v BNP Paribas*[39] in which the Court said:[40]

> The construction of the letters of indemnity is to be determined by what a reasonable person in the position of Pacific would have understood them to mean. That requires consideration, not only of the text of the documents, but also the surrounding circumstances known to Pacific and BNP, and the purpose and object of the transaction.

The decision in *BNP Paribas* has been identified by some as potentially representing 'a triumph for commercial construction'.[41]

In the 2007 case of *Gardiner v Agricultural and Rural Finance Pty Limited*,[42] Spigelman CJ considered the High Court's decision in *Andar* and more recent New South Wales cases that made reference to it. His Honour found that the principles of construction relevant to commercial contracts have, over the last few decades, been brought into line with the High Court's approach to statutory interpretation, which 'requires attention to the broader context of the words in issue in the first instance, not only after some kind of "ambiguity" has been identified'. His Honour concluded that 'there is more than one principle involved in the task of contractual interpretation, which must be undertaken in accordance with the general approach … applicable to commercial contracts'.[43]

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34 Andar (High Court) at 437.
35 Ibid at 435.
36 Ibid at 467.
37 Ibid at 466-467.
38 Ibid at 464.
39 [2004] HCA 35.
40 Ibid at [22].
41 E Peden and J W Carter 'Taking Stock: the High Court and Contract Construction' (2005) 21 JCL 172 at [180].
42 [2007] NSWCA 235.
43 Ibid at [11] to [13] per Spigelman CJ. Although this decision was overturned by the High Court on appeal, the majority did not revisit the construction issues canvassed in Andar in the course of doing so.

This view was subsequently echoed by McColl JA in *Waterways Authority of New South Wales v Coal & Allied (Operations) Pty Limited*,[44] although the 2008 decision of the New South Wales Court of Appeal in *Kooee Communications Pty Limited v Primus Telecommunications Pty Limited*,[45] whilst confirming the validity of *Gardiner*, warns of the adverse consequences of re-writing commercial contracts under the guise of interpreting them.

Approaches to indemnities in construction contracts

It follows that there are risks inherent in drafting an indemnity in broad terms and without sufficient regard to the circumstances in which the indemnified party may wish to have recourse to it.

What then ought a prudent practitioner do when advising clients in respect of the inclusion of indemnities in construction contracts?

It is important to bear in mind that notwithstanding the controversy discussed above, generally speaking, indemnities will be enforceable if thoughtfully and appropriately drafted.

In particular:

- Is the indemnity really warranted by the circumstances of the project in question or whether the issues sought to be addressed by its proposed inclusion are best left to common law or other contractual machinery. The guiding principle for the allocation of risk on construction contracts (ie. to the party or parties best able to manage it) should be the primary consideration at this point;
- Mutual indemnities regarding the same subject matter are frequently either redundant or operate inconsistently by reason of the differing roles of parties on a project;
- Indemnities drafted in the broadest possible terms may well fall foul of the approach in *Andar*. Care must be taken to identify with the greatest degree of clarity the circumstances in which they will apply and the loss and damage they will address. A failure adequately to identify either of these elements may result in the indemnity being read down and construed against the party seeking to rely upon it;
- Similarly, if it is intended that the indemnities are triggered even by the negligence of the indemnified party, the safest course is for the contract to be drafted so as to make this express. “Weasel words” are likely to be troublesome but then parties often resort to “weasel words” when they are being less than open about their intentions;
- Indemnities should be drafted so as to ensure consistency with other exclusion and limitation clauses in the contract.

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44 [2007] NSWCA 276 at [238].
45 [2008] NSWCA 5 at [30] to [38] per Basten JA, Giles and Tobias JJA concurring.