CONSTRUCTION LAW UPDATE – JUNE 2018

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This note summarises recent construction law decisions and developments in New Zealand.

Law	Issues	Decision / Principle
Body Corporate 200012 v Keene [2017] NZHC 2953	**Judicial review** of CCA adjudication **Res judicata** CCA , ss 58(3) 61(2) 68	Application for judicial review of two adjudicators' determinations dismissed. Judicial review of CCA adjudications is rare given the availability of other relief. Judicial review is only available if there has been a genuine excess of jurisdiction by the adjudicator, a serious breach of natural justice, or some apparent and significant error of law. Section 68 of the CCA (the confidentiality provision) did not stop a party putting before an adjudicator an earlier determination by another adjudicator involving the same parties/issues. Res judicata applies.
Body Corporate 20012 v Keene [2018] NZHC 814	**Costs** CCA, s 59	Costs decision following dismissal of an application for judicial review of two adjudicators' determinations (see above). The entitlement to actual and reasonable costs under s 59(2)(1)(ii) is confined to debt recovery proceedings initiated under s 59(2)(a). Naylor Love was therefore unable to recover actual and reasonable costs for opposing the judicial review application as the proceeding was not one of debt recovery. Scale costs were awarded instead.
Borlase v R [2017] NZCA 514 (CA)	**Bribery and corruption** Crimes Act 1961, s105	Over a period of 7 years Mr Borlase (Projenz Ltd) bribed local body official Mr Noone (Rodney District Council and Auckland Transport). As a result, Projenz successfully tendered for roading contracts with RDC and AT. Both men were convicted of charges under s 105 of the Crime Act 1961 (bribery

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		and corruption of a public official). The Court of Appeal held the purpose of s 105 does not require proof of an intention to influence the official to act in a certain way. Corruption existed here because payments were made additional to and outside of the official's salary via "*bogus contractual arrangements designed to disguise their true nature*". Both men knew that receipt of the benefits was inconsistent with a public official's duties. The Court upheld both sentences, holding that the cumulative pattern of offending over 7 years was "*criminality on a serious scale*".
Custom Street Hotel Ltd v Plus Construction NZ Ltd [2017] NZCA 36	**Termination provisions** NZS3910 Extra completion costs	Unsuccessful appeal by Custom from a HC decision (originally appealed from an arbitral award) which considered the meaning of the termination provisions in NZS 3910:2003 (clause 14). The appeal was limited to specific legal points. Of note: • Something less than repudiation *may* disentitle a party from terminating, such as breach of an essential term or a serious breach under s 7 of the Contractual Remedies Act 1979 (now the Contract and Commercial Law Act 2017). However, that will be the effect of such a breach only where the terminating party would otherwise benefit from its own wrong. Here, Plus had not repudiated or breached an essential term, so the application of this principle did not need to be considered. • Under clause 14.3.3 actual suspension is not required before the contractor could terminate. It is enough that a *right* to suspend arose before termination. Accordingly, the fact that the Engineer had not acted on Plus's request to suspend did not prevent Plus from terminating. • Under clause 14.2.4, a principal (here Custom) cannot recover the additional costs of another contractor completing the works until those works are complete (ie that clause does not allow recoverability of *projected* costs).
David Browne Contractors Ltd v Petterson Ltd [2017] NZSC 116	Solvency test **Contingent liabilities**	On the particular facts, a contingent liability (a damages claim for alleged welding failures on an infrastructure project) could be taken into account when determining whether or not a transaction was an insolvent transaction under s 292 of the

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		Companies Act 1993. An insolvent transaction is one made when a company must be able to pay its due debts and which enables the other party to receive a benefit in the company's liquidation The Supreme Court outlined a new test for assessing whether a damages claim is a "debt": a damages claim may be debt due for the purpose of s 292 if a reasonable and prudent businessperson would be satisfied that there is sufficient certainty that a claim will crystallise into a judgment debt in the relevant period (to be determined on the facts of each case).
Ebert Construction Ltd v Sanson & Anor [2017] NZCA 239	**Direct agreements with financiers and voidable preferences** Construction project financing Direct payment / tripartite agreements	Contractors presented with a direct agreement need to bear in mind the risk that payments made by a financier could be clawed back by a liquidator in the event of a principal's insolvency. To prevent this, the financier must have an obligation or "direct liability" (not a discretion) under the direct agreement to pay the contractor which is independent of the direction and will of the principal. A direct (or tripartite) agreement is one where the contractor may be paid directly by the financier, and the financier typically has "step in" rights if the employer defaults.
Floorman Waikato Ltd v MacRae [2017] NZHC 1063	Meaning of "Construction Work" under the CCA	Floorman was engaged by MacRae to sand and cost his floors. MacRae was dissatisfied with the works and refused to pay the claimed amount without issuing a payment schedule to Floorman. MacRae argued that the CCA did not apply because it only applied to jobs of new work, or jobs of a certain worth, or to jobs involving professional tradespeople. MacRae's arguments were flatly rejected. Floor sanding and coating work is "*construction work*" as defined in the CCA. When a compliant payment claim is issued and no payment schedule is issued, the claimed amount is recoverable as a debt due and owing regardless of the size of the contract or the amount at stake.
Honey Bees Preschool Ltd v 127 Hobson Street Ltd [2018] NZHC 32	**Penalties**	Following the UK and Australia, the Court departed from the longstanding 'genuine pre-estimate of loss' threshold test in *Dunlop Pneumatic Tyre Co Ltd* and adopted a wider 'legitimate interests' test. Under this

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		test, a clause is a penalty where the detriment to the contract-breaker is "*out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation*". In this case an indemnity clause if a lift was not installed by an agreed date was not a penalty as it was proportionate to Honey Bees' legitimate interests in operating a childcare business at capacity.
Jefferson v Straw Homes Ltd [2017] NZHC 1766	Estimated vs fixed price contracts **Duty of care for estimates**	A residential building agreement based on an estimate was not a fixed price contract. A reasonably and properly informed third party would consider the words "*contract price*" to mean the builder's estimated price. The subsequent conduct of the builder (Straw Homes) continuing to invoice after the estimate was exceeded and the lack of protest by the principal (Jefferson) was seen as objective evidence that the parties had not agreed to a fixed price. The builder owed a duty to provide accurate estimates, including for variations. That duty arose in circumstances where the principal was a residential homeowner, and the builder knew the principal had a limited budget and was using their estimate to obtain finance. The builder was negligent for failing to accurately advise the cost implications of variations. Nevertheless, the principal had not suffered any loss as they had received commensurate additional value.
Lot 8 Investment Ltd v RPS Construction Ltd [2017] NZHC 1400	Payment regime under the CCA	Section 21 of the CCA does not preclude a single payment schedule dealing with multiple payment claims, provided that delivery is made on time and the other requirements of the section are met. Section 21 does not require that a payment schedule contain a line-by-line assessment of each aspect of a payment claim.
Minister of Education v H Construction North Island Ltd (Formerly Hawkins Construction North Island Ltd) [2018] NZHC 871	**Negligence** **Leaky buildings**	Hawkins was liable in negligence to pay nearly $13.5m to the plaintiffs for the cost of repairing leaky school buildings that it had constructed between 2003 and 2009. Hawkins argued that the contract excluded it from liability stemming from design defects because it was a construction-only contract and also raised an affirmative defence in respect of the 10-year longstop provision in the Building Act. As to quantum, Hawkins submitted an alternative scope and costing.

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		The Court held that Hawkins was negligent in respect of five of the seven defects claimed by the plaintiffs. Liability stemmed from non-compliance of the Building Act / the building code. Hawkins' longstop defence was only partially accepted in respect of one of the listed defects. And its alternative costing was dismissed as it was not workable in terms of the building code.
Richina Pacific Ltd v AAI Ltd [2017] NZHC 1686	**Performance bonds** Practical completion	This decision is ultimately guided by the Court of Appeal decision below, but it is useful for the discussion on whether the contractor's bond was truly "on-demand" or conditional. By looking at the express language and overall purpose of the bond, the Court concluded that it was conditional and the principal was required to prove certain conditions had been met in order to call up the bond. The contractor had failed to perform its obligations under the contract, meaning the principal was entitled to under the bond monies.
Richina Pacific Ltd v Samson Corporation Ltd [2018] NZCA 132	**Performance bonds** Partial practical completion	The Court of Appeal upheld the High Court's decision (above) that a practical completion (**PC**) certificate was only issued for a separable portion of the works rather than for the whole works with an agreement for deferred work (in respect of an automatic car stacker). The contractor's argument that the bond had expired following the (partial) PC certificate was rejected. As the contractor had failed to install the car stacker, PC of the overall works had not been achieved, meaning the bond had not expired.
Southland Indoor Leisure Centre Charitable Trust v Invercargill City Council [2017] NZSC 190	**Duty of Care** of Local Authority Building Act 1991 Contributory negligence	The Supreme Court partially allowed an appeal of the Court of Appeal's decision in finding that a local authority owed a duty of care to a commissioning owner in issuing a CCC for a non-compliant building. Councils' duty of care arises from their regulatory role under the Building Act 1991. *Spencer on Byron* cannot be distinguished on the basis that the Trust was a commissioning owner, or that issuing a CCC differed from the councils' other functions (such as inspections) as all of these functions are directed at ensuring compliance with the Building Code. The majority also upheld the Court of Appeal's finding that the Trust was contributorily negligent, reducing the damages award by 50 per cent.

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Construction Contracts Act amendments	**Consultants**	It is nearly two years since the CCA was extended to consultants. The fears many consultants had about PI claims being adjudicated does not appear to have materialised. This is in line with overseas experience and our own assessment prior to this amendment coming into force (here).
Construction Contracts Act amendments	**Retentions**	The new retentions regime under the CCA has been in effect for over a year now. To date there have been no known proceedings or prosecutions for breach of the trust obligations. However, anecdotal evidence suggests there is still a wide range of approaches and knowledge about the regime. We note that the UK is currently considering a similar legislative change, albeit one that would require parties to pay retentions into an approved independent deposit scheme.
Updated standard forms	**SFA** **CCCS**	Two of the most commonly used standard agreements to engage consultants (SFA and CCCS) have been subject to review and new iterations have been released. The thrust of the main changes concern adding a requirements to give an 'early warning', updating suspension rights, providing for a quasi payment schedule procedure where the CCA does not apply and updating health and safety provisions. A more detailed discussion of the key changes is available (here).
ACP cladding	**Regulation** **Liability**	In New Zealand, MBIE has commissioned a peer review on Tony Enright's audit recommending suspensions of ACP cladding certification by CodeMark. MBIE is also in the early stages of a regulatory investigation of imported construction products, including ACP cladding as well as imported steel. In the UK, the Hackitt review was issued in May 2018 following the Grenfell Tower fire to make recommendations on the future regulatory system. Australia is currently reviewing its testing methods for fire performance of external walls and cladding under the BCA following the Lacrosse fire in Melbourne.
Engineer to the Contract	Duty of fairness and	The role of the Engineer to the Contract is a common

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	impartiality **Liability in tort** Scope for reform	source of contention between contracting parties. We recently examined the Engineer's obligations under New Zealand law, including whether they owe the contractor a duty of care in tort. Click here.

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Body Corporate 200012 v Keene [2017] NZHC 2953

The *Keene* case is significant as it showcases the perils of seeking judicial review from the Courts as a means of overturning adjudication determinations in the CCA context. In *Keene* the High Court rejected an application for judicial review of two determinations.

Facts

The plaintiff (**BC12**) and the third defendant (**Naylor Love**) had disputes relating to their construction contract, for remediation of leaky building defects in an 83 residential unit complex.

Disputes arose over variation claims, and BC12 and Naylor Love entered into two adjudications. In the first adjudication the adjudicator, Mr Keene QC, upheld various claims by Naylor Love totalling $3,246,215.26. BC12 disputed the bulk of this amount. In the second adjudication, a different adjudicator, Mr Cardena, upheld five separate claims by Naylor Love, relying in two of these on Mr Keene's earlier finding.

Naylor Love successfully applied to enter Mr Keene's determination as a District Court judgement and intended to do same with Mr Carden's determination. To avoid paying, BC12 applied for judicial review of the two adjudications.

First adjudication

BC12's grounds for review in relation to the first adjudication centred around four claims, referred to as EOT3, P&G thickening, rate escalation, and Hope Construction.

With the EOT3 claim, Naylor Love had sought an extension of time and prolongation costs. The dispute was referred to the Engineer, who issued a decision awarding an extension of time and prolongation costs on 10 September 2015. However, Naylor Love served its adjudication notice on 9 August 2016, seeking a further extension of time and further prolongation costs. BC12 contended there was no dispute capable of being referred to adjudication under the CCA because Naylor Love had not referred the matter to mediation, arbitration, or adjudication within the specified contractual timeframe. BC12 argued this meant that the engineer's decision was binding on the parties and the adjudicator had no jurisdiction to consider the EOT3 claim.

With the P&G thickening and Hope Construction claims, BC12 contended that the adjudicator had decided claims that were not referred to him. BC12 also argued that there was a failure on the adjudicator's part to apply the principles of natural justice in 1) deciding a claim over which he did not have jurisdiction and 2) not giving BC12 prior notice it was facing such a claim and an opportunity to be heard.

With the rate escalation claim, BC12 argued the adjudicator did not have jurisdiction to make the award as the special conditions of the contract precluded a claim for rate escalation.

Second adjudication

As for the second adjudication, BC12 argued that the second adjudicator made a fundamental error of law in finding he was bound by the first adjudication as the principle of *res judicata* does not apply to a determination under the CCA.

High Court

The High Court rejected the application for judicial review.

The Court first discussed the proper approach to applications for judicial review, noting that it is not an appeal against the challenged decision. Judicial review is primarily concerned with examining the decision making process and not the substance of the decision. Although the Courts retain a broad discretion to judicially review the determination of an adjudicator, where matters in dispute can be resolved in another forum the Court will be sparing in the exercise of its jurisdiction. The Court cited the Court of Appeal's decision in *Rees v Firth* [2011] NZCA 668 with approval. It further noted that bringing a judicial review application to avoid the 'pay now, argue later' policy of the CCA clearly cuts across the CCA's scheme, and that it would require a genuine excess of jurisdiction by the adjudicator, a serious breach of natural justice, or some apparent and significant error of law for intervention to be warranted.

First adjudication

Applying these principles to the facts, the Court held in relation to the EOT3 claim that the adjudicator did have statutory jurisdiction to determine the dispute under the CCA as there was a dispute within the meaning of s 5 of the CCA ("a dispute or difference that arises under a construction contract"). The Engineer's decision did not change that. The issue was whether in light of the contract's terms the adjudicator should have exercised that statutory jurisdiction, which is a matter of contractual interpretation. Challenging the correctness of an adjudicator's decision is a matter for appeal rather than judicial review. Although a decision will be reviewable if it is based on a material or significant error of law, this was not true of the present case.

As to the P&G thickening and Hope Construction claims, these matters did not go to jurisdiction but to contractual interpretation. The adjudicator made his determination on the substance of the dispute and there was no breach of natural justice.

Similarly, the rate escalation claim involved a matter of contractual interpretation, not jurisdiction.

Second adjudication

The Court found that the adjudicator did not make a fundamental error of law in concluding that he was bound by the earlier adjudicator's findings. Sections 58(3) and 61(2) of the CCA[1] had the effect of stating that a determination would not bind the court or arbitrator, but had no relevance to a subsequent adjudication on the same issues. The purpose of s 68 of the CCA (the confidentiality provision) is to keep information confidential to the parties. Section 68 does not prohibit a party putting before an adjudicator a determination by another adjudicator involving the same parties and related issues. Indeed, this is necessary, because *res judicata* applies.

Comments

This case highlights that whilst the courts can judicially review adjudicator's determinations, they will exercise that jurisdiction sparingly. A decision will only be reviewed if there has been a genuine excess of jurisdiction by the adjudicator, a serious breach of natural justice, or some apparent and significant error of law. Attempts to use judicial review to circumvent an adjudication determination in the CCA context are unlikely to succeed.

[1] Repealed by ss 41(2) and 44 of Construction Contracts Amendment Act 2015, but the construction contract was entered into before 1 Dec 2015, so the amendments did not apply.

Custom Street Hotel Ltd v Plus Construction NZ Ltd [2017] NZCA 36

This was an unsuccessful appeal by Custom Street Hotel Ltd (**Custom**) from a High Court decision (originally appealed from an arbitral award) which considered the meaning of the termination provisions in NZS 3910:2003 (the predecessor to NZS 3910:2013).

Background

The parties entered into a $14.45m contract to convert an existing building into a hotel. The project was inundated with issues. The contractor, Plus Construction NZ Ltd (**Plus**), blamed Custom's failure to obtain consents, while Custom asserted that Plus could still progress the works and had under-resourced the project and ultimately walked off the job.

Plus issued a default notice under clause 14.3.1(b) for two unpaid payment claims totalling c$258,000. Under the contract, Custom had 10 working days to pay otherwise suspension/termination rights would arise. During the 10 working days, the Engineer suspended the works at Custom's behest alleging Plus was in breach of site safety requirements. Custom did not pay the outstanding amount within the required time and Plus then purported to require the Engineer to suspend the contract works under clause 14.3.3 (although this was already suspended). The next day Plus wrote giving notice of termination and Custom also paid the claimed amount.

Custom challenged the validity of Plus' termination and issued its own notice of default, which included a contention that Plus had abandoned the contract. Plus, operating on the basis that it had already validly terminated, did not act on Custom's notice. Custom therefore, purported to terminate the contract itself on the basis that Plus's termination was invalid, and claimed damages from Plus for the increased cost of the having the works completed by another contractor. Custom also sought to call up a performance bond which required certification by the Engineer.

The parties referred these issues to arbitration. In the meantime, they agreed the bond monies would be placed in escrow pending the outcome. By this time the Engineer had also certified that $24.9m was due to Custom for the additional costs of another contractor completing the works.

The arbitrator found Plus had validly terminated the contract and could not have been in default when the Engineer issued his default certificate. The arbitrator also found the Engineer had wrongly certified payment of $24.9m, and that a claim for additional costs to complete the work was governed by clause 14.2.4 and could only be determined on completion of the works.

Unsuccessful on appeal in the High Court, Custom further appealed to the Court of Appeal (**CA**) on specific points of law.

Repudiation disentitling termination

Custom argued that Plus was not entitled to terminate because it had repudiated the contract by ceasing work, removing scaffolding and breaching health and safety requirements. However, the arbitrator held that there was nothing to indicate Plus was not committed to the contract.

The CA, agreeing with the arbitrator and High Court, that a breach by Plus did not need to be repudiatory before they would be disentitled from terminating the contract. Something less, such as breaching an essential term or a serious breach under s 7 of the Contractual Remedies Act 1979 (**CRA**) (now, the Contract and Commercial Law Act 2017 (**CCLA**)), may suffice. However, for such a breach to disentitle the party from terminating, it would have to mean that it would otherwise benefit from its own wrong. Here, Plus had not repudiated or breached an essential term, meaning the question of whether it was disentitled from terminating did not arise.

Termination by contractor under clause 14.3.3

Under clause 14.3.3, if the principal is in default the contractor can give 10 working days notice to remedy the default. If the default is not remedied, the contractor can require the Engineer to suspend the work and, following that suspension, the contractor can terminate. In this case, the Engineer had not acted on Plus' request to suspend as the works were already suspended at the behest of Custom. Custom contended that both the notice to suspend and the suspension were required before termination under clause 14.3.3 could occur based on the words "*following such suspension*". Adopting a purposive interpretation, the CA rejected this - holding that actual suspension was not required under clause 14.3.3 before the contractor could terminate. It was enough that *a right* to suspend arose before termination.

Additional costs to complete under clause 14.2.4

Custom claimed from Plus the *projected* additional costs of having another contractor complete the works under clause 14.2.4. The CA agreed with the High Court that the quantum of any such claim under clause 14.2.4 could only be assessed once the works were completed, and could not be based on projected costs. Its reasoning was five-fold. Clause 14.2.4 says specifically "*on completion of the Contract Works*". Second, an interpretation that required splitting the works within clause 14.2.4 would be an awkward and unnatural interpretation that would not have been intended in this type of contract. Third, clause 14.2.4 follows in sequence with clause 14.2.3 (principal resuming possession). Fourth, the language of clause 14.2.4 presumes the works are completed. Finally, given the certification process under clause 14.2.4 may lead to a payment being made to the contractor, this indicated the wash-up task in 14.2.4 would only occur after completion since any further payments to the contractor are suspended until then.

David Browne Contractors Ltd v Petterson (as Liquidator of Polyethylene Pipe Systems Ltd (In Liq)) [2017] NZSC 116

In *David Browne Contractors Ltd v Petterson* [2017] NZSC 116, the Supreme Court laid down a new test for determining when a company is unable to pay its due debts under s 292 of the Companies Act 1993.

The solvency test under s 4 of the Companies Act has two parts: a company must be able to pay its debts as they become due in the normal course of business (the cash flow test) and the value of the company's assets must be greater than the value of its liabilities, including its contingent liabilities (the balance sheet test). When assessing the value of a contingent liability, account must be taken of the likelihood of the contingency occurring and any claim the company has that can be reasonably be expected to reduce or extinguish that contingency.

Notwithstanding the two parts to the solvency test, the definition of an insolvent transaction in s 292 refers only to the cash flow test. An insolvent transaction is a transaction entered into by a company at a time where the company is unable to pay its due debts and which enables another person to receive more towards satisfaction of a debt owed by the company that the person would receive, or likely receive, in the company's liquidation (s 292).

The issue in *David Browne Contractors Ltd* was whether a contingent liability (a damages claim) could be taken into account when determining whether or not a transaction was an insolvent transaction.

Facts

The claim involved three related companies controlled by Mr David Browne: Polyethylene Pipe Systems Ltd (in liquidation) (**Polyethylene**); David Browne Contractors Ltd (**Contractors**); and David Browne Mechanical Ltd (**Mechanical**). The liquidators of Polyethylene sought to claw back payments made by Polyethylene to Mr Browne, Contractors and Mechanical within two years of its liquidation.

In March 2007, Polyethylene subcontracted with McConnell Dowell to perform welding work on polyethylene pipes for a sewer outfall. There were successive failures of three welds. It was initially unclear whether the welds were faulty, or whether the failures were caused by stress placed on the pipes during installation. Various experts reviewed the failures and the evidence increasingly pointed to faulty welds.

In June 2008, McConnell Dowell notified Polyethylene that its investigations indicated that the welds were at fault. It said that it had suffered significant losses, which it would seek to recover under the subcontract (which included an indemnity). Polyethylene had already been told by a loss adjuster that the loss should fall within the contract works policy held by McConnell Dowell. The loss adjuster had not reviewed the policy wording and a claim had not been made on the policy by either McConnell Dowell or Polyethylene.

Ten days after McConnell Dowell's notification, Polyethylene resolved to repay unsecured advances made by Mechanical, Contractors and David Browne. Polyethylene also decided to transfer shares it held in a related company to Mr Browne's family trust for less than half of their value in Polyethylene's 2008 accounts. The share price was advanced by Polyethylene to the trust, and did not have to be repaid for 20 years. Mr Browne agreed to advance $450,000 to Polyethylene as working capital, which would be secured by a GSA.

Polyethylene's directors signed a certificate of solvency. In relation to McConnell Dowell's claim, they stated that the claim was disputed, would be offset by extras and variation claims and would be covered by McConnell Dowell's contract works insurance policy.

In the High Court, Associate Judge Matthews held that these transactions were part of a legitimate business restructure. The Court of Appeal and Supreme Court held that their purpose was to safeguard Mr Browne and his interests from McConnell Dowell's claim.

Polyethylene repaid the unsecured advances by Mechanical, Contractors and Mr Browne in September 2008. By that time, McConnell Dowell had provided a breakdown of its losses in relation to two of the weld failures and had disputed the availability of insurance cover.

McConnell Dowell issued an adjudication claim in 2009, which was determined by Derek Firth on 20 July 2009. He assessed recoverable losses at c$3m. The determination was subject to an adjustment to account for the impact of insurance, as Mr Firth did not have sufficient information to determine whether cover was available and the level of the deductible.

Mr Browne then appointed a receiver for Polyethylene under the GSA. Polyethylene was put into liquidation on 5 October 2009, on the application of McConnell Dowell. In 2013, the liquidator served notices on Mechanical and Contractors under s 294 of the Companies Act to set aside the September 2008 payments. The accountants who received the notices did not pass them on, and the transactions were automatically set aside 20 working days after the notices were served. The liquidator then issued proceedings against Mechanical and Contractors to recover the payments.

The liquidator also served a notice on Mr Browne to set aside the payment made to him in September 2008 and the GSA. Mr Browne filed an objection within time, and the liquidator brought proceedings claiming that both the payment and GSA were voidable. The liquidator also applied to set the GSA aside under s 299 (which applies to charges in favour of directors, controlling shareholders and related companies).

Associate Judge Matthews held that Polyethylene was able to pay its due debts and was solvent at the time of the September 2008 payments and entry into the GSA. The claims against Mr Browne accordingly failed. As Mechanical and Contractors had not filed an objection to the liquidator's notice, their transactions had been automatically set aside. The Associate Judge held that the Court had a discretion under s 295 to decline recovery to a liquidator in circumstances where it was just to do so. There was no basis for the liquidator's notices, and recovery was therefore declined.

The liquidator appealed and was successful. The Court of Appeal set the GSA aside, and ordered Mechanical, Contractors and Mr Browne to repay Polyethylene.

Due debts

The Supreme Court held the term "debt" encompasses both present and contingent debts. "Due debts" includes debts that will be become due in the future if there is "reasonably temporal proximity". What constitutes reasonably temporal proximity will depend on the facts of the case.

A damages claim, once determined, will become a judgment debt. The Court noted that a damages claim under a construction contract can be determined by adjudication within a short timeframe. If the outcome of the determination has reasonably temporal proximity to the transaction under scrutiny, the damages claim may be a debt due.

The Supreme Court accordingly outlined the following test: a damages claim may be debt due for the purpose of s 292 if a reasonable and prudent business person would be satisfied that there is sufficient certainty that a claim will crystallise into a judgment debt in "the relevant period". The relevant period is a period of reasonably temporal proximity to the transaction, and is determined on the facts of each case.

The Court emphasised that solvency in a cash flow sense must be assessed objectively from a practical business perspective: a company may be insolvent even if it is able to pay its debts "for the next few days, weeks, or even months before an inevitable failure."[2]

When the September 2008 payments were made, it would have been clear to the directors of Polyethylene (who were also the directors of Mechanical and Contractors) that the company would be unable to discharge its liability to McConnell Dowell for losses flowing from the faulty welds. Although adjudication proceedings had not yet issued, McConnell Dowell's claim was a due debt, and the transactions were insolvent.

Mechanical and Contractors submitted that this interpretation of s 292(2)(a) would require companies to cease trading when faced with a specious claim. The Supreme Court was unconvinced. In its view, the test is not unduly wide: if a reasonable and prudent business person would not be satisfied that there is sufficient certainty that the claim will crystallise in the "relevant period", the claim will not be a due debt.

Implications

The Supreme Court's test for a due debt introduces significant uncertainty for directors when assessing the solvency of a company. Reasonable and prudent persons frequently disagree on the likely outcome of litigation. Associate Judge Matthews, for example, took the view that at the time of the transactions in issue, there was significant doubt as to the cause of the weld failures and the availability of insurance.

The Supreme Court placed considerable emphasis on the adjudicator's finding that there was no defence to McConnell Dowell's claim. Mr Firth is a very experienced adjudicator and his ruling may well have been right. However, adjudication is a summary process that is undertaken without an oral hearing or the opportunity for cross-examination. It is dangerous to assume that the same conclusion would necessarily have been reached had the matter proceeded to arbitration.[3] The rough and ready nature of adjudication arguably means that there is significant litigation risk in all but the most hopeless of claims.

The flexibility allowed by the concept of "reasonably temporal proximity" adds to the uncertainty. Does the availability of adjudication mean that all robust construction claims must be considered due debts? The adjudication proceedings in David Browne Contractors were initiated months after impugned transactions occurred.

The Supreme Court noted that while a company that is unable to meet its due debts is not permitted to make preferential transactions, it may still continue trading. However any decision to continue trading must take provisions under the Companies Act for reckless trading into account (s 135). Directors who dishonestly allow a company to incur debt while knowing it is insolvent may also commit an offence under s 380(4) and be liable for a term of imprisonment of up to 5 years, or a fine of up to $200,000.

It will be interesting to see how the new test works in practice. As noted, the Supreme Court's view is that the test is not unduly wide. The lower Courts may take this as a signal that account should only be taken of very strong claims, for which judgment is imminent. For parties to construction contracts, there may be advantages in initiating adjudication proceedings in some circumstances, to remove the uncertainty of contingent claims for business operations.

[2] At [90], citing *Re Cheyne Finance Plc (No 2)* [2007] EWHC 2402, [2008] 2 All ER 987 (Ch) at [51].
[3] Accepting that additional information may have been before the Court than is reflected in the judgment.

Ebert Construction Limited v Sanson [2017] NZCA 239

The Court of Appeal allowed an appeal by Ebert Construction Limited (**Ebert**) which challenged the ability of the liquidators of a developer company to claw back payments made by a financier under a direct payment agreement. The Court held that the payments made by the financier were under a direct obligation to a builder, and were therefore not payments by the insolvent company, and were therefore not subject to the insolvent transactions regime. The form of direct payment agreements or tripartite agreements will be important, particularly in voidable transaction cases.

Background

In October 2005 Takapuna Procurement Limited (**TPL**) entered into a construction contract with Ebert to construct the 134-unit Shoalhaven Apartments complex at Takapuna for approximately $32,500,000. TPL arranged finance with BOS International (Australia) Limited (**BOSI**) through a Senior Facility Agreement and Strategic Nominees Limited (**Strategic**) through a Junior Facility Agreement.

The direct agreement

Ebert, BOSI and Strategic entered into a "direct agreement" in relation to the project.

Direct agreements generally provide for a contractor's progress payments to be paid directly by the financier. They typically provide a financier with "step in rights" if a developer defaults on their obligations. The direct agreement in this case included the following relevant features:

1. BOSI was required to pay Ebert progress payments due under the construction contract provided a) BOSI had received an approval payment certificate for the amount to be paid and b) Ebert was not in default of its obligations under the construction contract.

2. TPL gave an irrevocable authority for these payments to be made by BOSI direct to Ebert.

3. BOSI and Strategic could only terminate TPL's finance facilities if they first paid duly approved progress payments to Ebert.

4. Neither BOSI nor Strategic had any liability or obligation to Ebert other than as provided in the direct agreement. TPL remained "primarily liable" for all obligations under the construction contract. However, BOSI had the right to step in and complete the project if TPL defaulted on its obligations under the construction contract.

5. A default by TPL under its loan facility agreement did not discharge BOSI from its obligations to Ebert under the direct agreement. This provision was described as unusual in direct agreements.

Completion of the project and insolvency

The apartments were completed in April 2008. TPL defaulted on the loan facility with BOSI in July 2008. In November 2008, TPL and Ebert agreed that the final amount owed to Ebert was $1,603.891.90, which would be paid by way of two cash payments and settlement of the apartment. TPL issued drawdown notices, and BOSI made payments in accordance with those notices. An arrangement for the sale of one of the apartments with Ebert as nominated purchaser was also entered into.

TPL was put into liquidation within a few days of these transactions on the application of the Inland Revenue Department.

In the High Court, Associate Judge Doogue held that the two cash payments and the transfer of the apartment were voidable transactions and ordered repayment of $1,603,891.90 plus interest. Ebert appealed.

A direct liability to pay

The Court of Appeal allowed the appeal. The key reason was its finding that BOSI had an obligation, as a principal debtor under the direct agreement, to pay Ebert if certain conditions were met. As a result, the payments were not transactions "by" TPL (as required under s 292 Companies Act 1993), nor did they allow Ebert to receive more than it would otherwise have received in the litigation (as Ebert always had a right to sue BOSI directly).

The Court noted also that the funds paid by BOSI to Ebert would not have been available to any other creditor, and accordingly did not form part of the general resources of the company. While that is true, it should be noted that the payments made by BOSI to Ebert had the effect of increasing the level of secured debt, and thus reducing the general resources of the company that were available to unsecured creditors.

It is also important to note that the features of the direct agreement which led the Court to its conclusion are not common to all direct agreements. The Court observed that it is unusual for the financier to have an obligation to pay a contractor in circumstances where the principal has defaulted on the loan agreement. If a direct agreement provides that direct payments are at the discretion of the financier, the payments may still be vulnerable to claw back in the event of insolvency.

Implications

Contractors presented with a direct agreement need to bear in mind the risk that payments made by a financier could be clawed back by a liquidator in the event of the principal's insolvency. To prevent this, the financier must have an obligation (not a discretion) under the direct agreement to pay the contractor that is independent of the direction and will of the principal.

Honey Bees Preschool Ltd v 127 Hobson Street Ltd [2018] NZHC 32

The High Court recently clarified the New Zealand position on when the penalties doctrine might be engaged.

Facts

Honey Bees Preschool Ltd (**Honey Bees**) leased premises from 127 Hobson Street Ltd for the purposes of operating a childcare centre. The lease required the landlord to install a second lift on the premises and, if this was not operational by 31 July 2016 (some 31 months after the Deed of Lease was executed), to indemnify Honey Bees against all obligations it may incur in relation to the premises (including rent and other expenses). This indemnity would have the effect of allowing Honey Bees to occupy the premises for approximately two years rent-free.

Scope of penalty doctrine

The Court first considered the competing approaches to the scope of the penalty doctrine in Australia and the UK. The UK Supreme Court has ruled that the penalties doctrine is only engaged where breach of a primary obligation (eg failure to provide goods as required by contract) results in the triggering of a secondary obligation (eg payment of a fee or damages).[4] The High Court of Australia did not consider a breach of contract as required for the penalty doctrine to be triggered and that a primary obligation could be construed as a penalty.[5]

Whata J preferred the approach of the UK and held that the penalties doctrine extended only to secondary obligations. While the indemnity provision in the lease resembled a conditional primary obligation, in substance it was akin to a secondary obligation and therefore was within the scope of the penalties doctrine.

When is a clause a penalty clause?

The High Court then considered when a secondary obligation would amount to a penalty. Prior to *Honey Bees*, New Zealand followed the longstanding threshold tests outlined by Lord Dunedin in *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd.*[6] Lord Dunedin said that a clause will be an unenforceable penalty if it is 'extravagant and unconscionable' and not a 'genuine pre-estimate of loss' arising from a breach.

Recent case law from the United Kingdom and Australia has departed from the concept of 'genuine pre-estimate of loss' – instead adopting a wider legitimate interest test. Under this test, a clause is a penalty where the detriment to the contract breaker was "*out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation*".[7]

In applying the 'legitimate interest' test, Whata J considered the following factors were relevant in concluding that the obligation to indemnify was not a penalty:

(a) Honey Bees' concerns regarding non-performance were legitimate.

(b) The defendant had 31 months to install the lift without triggering the indemnity provisions.

(c) The defendant should have known the importance of the lift to the plaintiff's business.

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[4] *Cavendish Square Holding BC v Makdessi* [2015] UKSC 67.
[5] *Andrews v Australia New Zealand Banking Group Ltd* [2012] HCA 30, (2012) 247 CLR 205; *Paciocco v Australia New Zealand Banking Group Ltd* [2016] HCA 28, (2016) 258 CLR 525.
[6] *Dunlop Pneumatic Tyre Co Ltd v New Garage and Motor Co Ltd* [1915] AC 79 (HL).
[7] *Andrews* above n 2 at [32].

(d) The landlord's non-performance would affect the plaintiff's ability to operate a successful childcare facility at capacity.

(e) Both parties were commercially astute. The defendant was an experienced property developer who managed 12 commercial properties. Any vulnerability it possessed was self-imposed through its reliance on internal expertise rather than seeking legal advice from its solicitor.

(f) The purpose of the indemnity clause was to ensure performance, not to punish the defendant.

Significance of decision

The High Court has clarified the approach to penalty clauses in New Zealand. In adopting the "*legitimate interest*" test the Court has arguably narrowed the circumstances in which clauses will be unenforceable penalties, albeit this is still to be affirmed by appellant higher court.

Southland Indoor Leisure Centre Charitable Trust v Invercargill City Council [2017] NZSC 190

The Supreme Court allowed a partial appeal of the Court of Appeal's decision in finding that a local authority owed a duty of care to a commissioning owner in issuing a CCC for a non-compliant building.

Facts

The appellant Trust built the Southland Stadium between 1999 and 2000. During construction, the roof design was identified to be defective. The Trust engaged an independent structural engineer to review the design, who provided a remedial solution. Conditions of consent for the remedial design required the Trust's engineer to provide a PS4, confirming that the work had been constructed in accordance with the consented remedial design, and information in support. The remedial work was not constructed per the design or inspected by the Trust's engineer. The consent conditions were therefore not met. The respondent Council nonetheless negligently issued an interim CCC in November 2000. In January 2001 the Trust's engineer provided further information to the Council which did not comply with all the conditions of the building consent, but the Council issued a final CCC in April 2003.

In 2006 the Trust's engineer recommended an inspection of the roof's truss welds and support fixings by a qualified person, but this was not done.

As a result of the defective remedial work the Southland Stadium's roof collapsed after snowfall in September 2010. The Trust sued the Council in negligence and negligent misstatement in relation to the remedial work.

High Court

The High Court (Dunningham J) found the Council owed a duty of care to the Trust when issuing the CCC and there was no reason to distinguish the Supreme Court's decision of *Spencer on Byron*, which held that a territorial authority's duties under the Building Act 1991 were owed to both original and subsequent owners 'regardless of the nature of the premises'. The High Court held that the Council owed a similar duty of care in respect of issuing CCCs to commissioning owners.

The High Court also concluded the Council was negligent in issuing the CCC for remedial works to the stadium roof trusses when it had no information on which it could reasonably have concluded the work complied with the Building Code. Dunningham J also found that the Trust was not contributorily negligent in failing to implement the engineer's 2006 recommendation to inspect. The Trust recovered the GST exclusive cost of rebuilding the stadium and lost rental (c $15.2m total) less $750,000 for betterment.

The Council appealed the High Court's decision.

Court of Appeal

The Court of Appeal allowed the appeal. It held that the Trust's claim against the Council was for negligent misstatement, rather than ordinary negligence, notwithstanding that the pleading was framed in both.

The majority judges (Harrison and Cooper JJ) held it would not be fair, just or reasonable to impose a duty of care on a Council to protect a property owner against loss caused by the negligence of its own agents. The majority also held that there was no assumption of responsibility by the Council for the Trust giving rise to the special relationship necessary for a claim for negligent misstatement. It could not be inferred that the Council knew that the Trust would use the CCC to satisfy itself that the stadium complied with the Building Code without further independent inquiry, nor was there evidence that it in fact did so. The Trust engaged third parties (contractors/consultants) to design and construct the stadium, and assumed control over the design and

construction functions. The Trust relied on its contractors and consultants, not on the Council, and was the party best placed to take care to avoid loss.

The minority (Miller J) believed the Council had assumed a limited duty to check appropriately qualified persons had supplied adequate evidence that consent conditions had been met. Miller J considered that the Council had breached this duty by issuing the CCC without the PS4 and other information required under the consent. However, he agreed with the majority that the Trust had not proved that it in fact relied on the CCC for assurance that the work complied with the Building Code.

The Court of Appeal unanimously held the Trust relied on its own contractors/consultants, not the Council, meaning the negligent misstatement action failed for lack of specific reliance. The Court also unanimously considered that the Trust had been contributorily negligent in failing to follow the 2006 engineer's recommendations and reduced the damages award by 50 per cent.

Supreme Court

The Trust appealed to the Supreme Court. The two principal issues for consideration were:

(a) Whether the case was distinguishable from *Spencer on Byron*.

(b) Whether the Trust was contributorily negligent.

On the first question, the Supreme Court unanimously held that the High Court was correct and that the Court of Appeal had erred in distinguishing *Spencer on Byron*. The duty of care on councils under the Building Act 1991 springs from the councils' regulatory role under that Act. This role was different from commissioning the building work or undertaking the construction. The distinction that the Council sought to draw on the basis that the Trust was a commissioning owner was not one made in the legislative scheme. Nor was there a valid distinction between the issuing of a CCC and councils' other functions, such as granting of a building consent or inspections. All of these functions were directed at ensuring buildings complied with the Building Code, meaning the duty was not obviated by another party's negligence or knowledge. As a matter of policy, the actions and knowledge of independent contractors were not attributed to the owner.

The Supreme Court further held that the claim should have been characterised as one of negligence, and not negligent misstatement.

A majority (Elias CJ, O'Regan and Ellen Frances JJ) upheld the Court of Appeal's finding that the Trust was contributorily negligent in not following the 2006 engineer's recommendations for inspection and that damages should be reduced by 50 per cent.

Comments

In reversing the Court of Appeal's decision, the Supreme Court has clarified that local authorities owe a duty of care to all building owners, including commissioning owners who have engaged their own contractors. Such owners will have recourse in negligence where a local authority has not met its duty of care.

Commissioning owners should be aware, however, that their own negligence to ensure compliance with building standards could mean a finding of contributory negligence and a reduction in damages in consequence.