

Back-to-backing subcontracts

A new decision illustrates what happens when things fall between the cracks when the prime contractor is liable but can't recover from the wayward subcontractor causing the problem.

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Prime contractors using subcontractors is a key part of many ICT and other projects. In an ideal world, the subcontract terms mirror the prime contract terms. But in the real world, doing that every time would be unwieldy. Where do you draw the line?

In a recent decision,¹ the court applied the leading Privy Council authorities² on implied terms. In doing so, it stopped a prime contractor recovering from a subcontractor, where the prime contractor paid Liquidated Damages (LDs) to its customer, in circumstances where it said that the liability was caused by the subcontractors' breach.

How LDs and SLA regimes work

LDs, and similar regimes such as sums payable by contractors if SLAs are not met, are designed to simplify the recovery of damages from suppliers in breach of their contracts. Instead of having to go through the difficult and often expensive process of working out what the actual damages are (such as loss of profit), the liability is fixed at specified amounts, payable on the stated triggering events. If for some reason, the LD clause doesn't work, the claimant goes through that usually difficult and expensive process (the so-called "damages at large" or unliquidated damages process).

What happened in the new case

In the 2012 case, WCL won a tender as prime contractor, and brought in CSL as subcontractor. Known to CSL was that the prime contract would have provisions for payment of LDs if there was breach. CSL, when presented with a form of subcontract containing back-to-back terms,

didn't sign it. Instead the subcontract proceeded on a mixture of oral and written terms (the writing consisting of letters, etc). There was no express mention in those vague arrangements of an LD regime.

WCL ended up shelling out money to its customer under its LD provision, based on delays caused, said WCL, by CSL's delays. WCL argued that there should be a term implied into the subcontract that there would be back-to-back LDs.

The High Court said no.

Implication of terms into contracts

The court applied the Privy Council cases on implication of terms. One of the tests used³ is that implication of the term into the contract "goes without saying". Another test is the implication of the term "is necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it".⁴ In short, the subcontract worked without an LD clause. The clause didn't have to be inserted to give business efficacy, and inserting it wouldn't "go without saying". Additionally, implication would have been contrary to the subcontractor's rejection of signing the subcontract that would have brought in the LD clause.

Where did that leave the prime contractor?

The effect of this decision was that WCL did not recoup any sum from the subcontractor. As there was no LD provision in the subcontract, WCL could have sued for damages at large. They couldn't here because of a pleading concession. But the reality was that there was no way,

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regardless, WCL would have claimed damages at large, because the cost of doing so was too high relative to any judgment in its favour. And that is quite common.

Where's the line to be drawn?

Despite this problem, there is a commercially realistic argument that, on balance, it was better to avoid the negotiations and hassles of getting a true back-to-back in place, and then to take the risk of the damages scenario turning pear shaped. For example, what does a prime contractor do, faced with negotiating with a multi-national ICT provider with fixed views and positions on its terms? It is not enough always to say, "We will insist on a full back-to-back".

We are not saying that suppliers should be a push over. Far from it, because getting back-to-backs right is important. But the reality is that it will be difficult to do this all the time. This all comes back to figuring out: "What is important to get back-to-backed?". Often a key focus should be on ensuring the scope and nature of the work to be done integrates closely with what is required under the main contract.

And, when talking of commercial reality, it is rare in our experience for suppliers to actually have to pay up on LD and SLA obligations. So, when assessing: "What is important?", there is a parallel question: "Why is it important?". An LD clause in the real world is not so important because people actually pay up on them (although one reason for that is that LDs and SLA payments tend to be quite small in relative terms and it is not worth customers seeking payment). It is more important for some other reason: for example, the payments due on breached SLAs are typically so small that no customer would bother seeking payment. In other words they act for the benefit of the supplier not – contrary to what appears at first sight – for the benefit of the customer.⁵

1. *Concrete Structures v Waiotahi Contractors* [2012] NZHC 787. This was a successful appeal from a District Court decision.
2. *BP Refinery v Shire of Hastings* (1977) 180 CLR 266 and *AG of Belize v Belize Telecom* [2009] 1 WLR 1988
3. No longer is the Court confined to dealing with all five limbs of the *BP Refinery* case: in *Belize*, the Privy Council confirmed that the five tests are a collection of different ways of approaching the issue
4. *BP Refinery* at page 283
5. Although a further factor is a non-financial one: it is not a good look for suppliers to breach SLAs so they will seek to comply with them regardless of financial penalties

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