MANAGEMENT CONTRACTING: LOW RISK FOR CONTRACTOR – LOW RECOVERY BY EMPLOYER

Peter W B Barber, Solicitor, Clifford Chance Prize Paper

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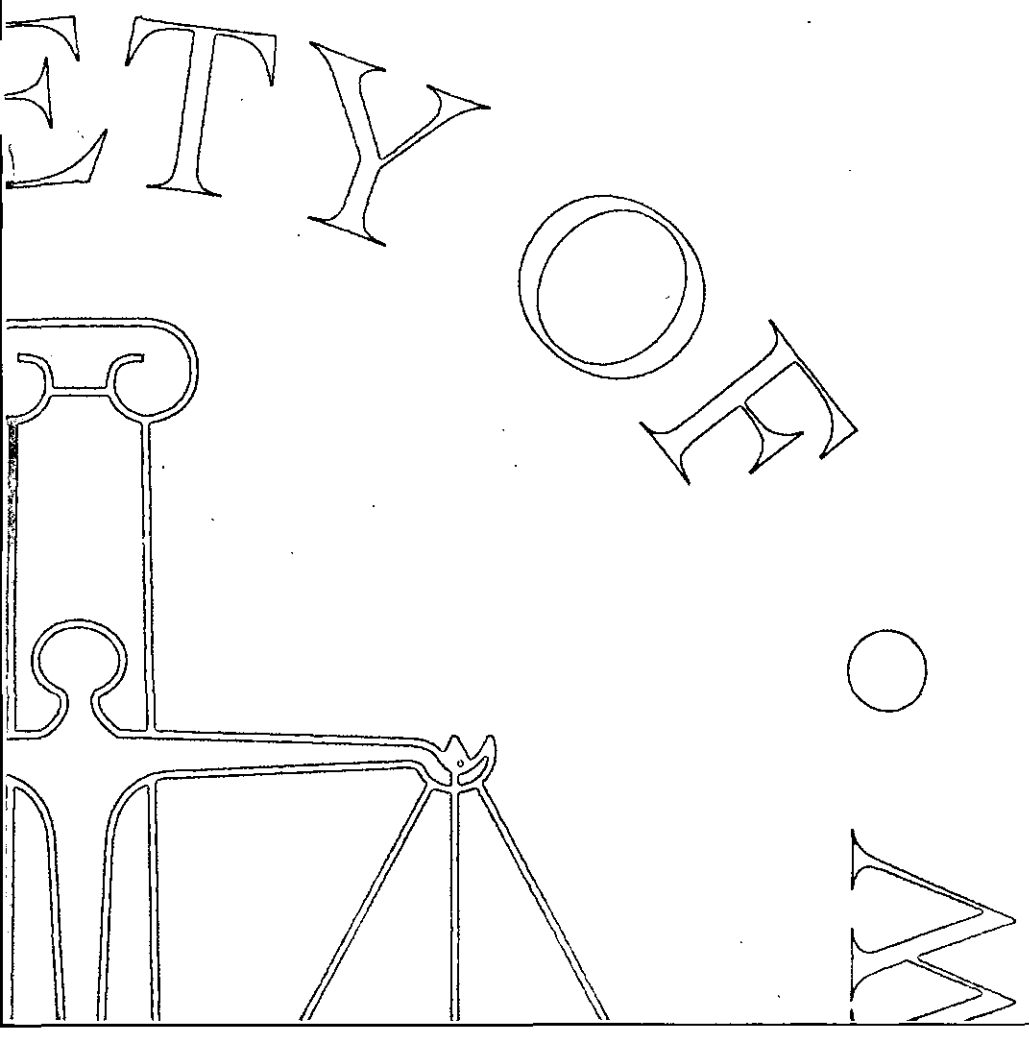

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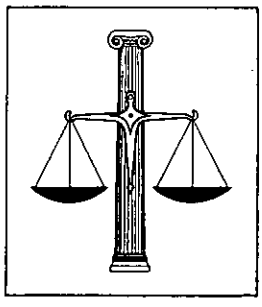

Society of Construction Law

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Peter Barber was born in 1953 and educated at Chigwell School, Essex and Magdalen College, Oxford, qualifying as a barrister in 1975.

He joined STC as legal adviser in 1977 and in 1980 became Assistant Regional Counsel of ITT Corporation (Asia Pacific Region) based in Hong Kong. In both positions he gained substantial first-hand experience of international joint ventures, contracts and tenders across a wide range of jurisdictions.

He requalified as a solicitor in 1983 and joined Clifford Chance in London in 1984. He is now a senior lawyer in the firm's Commercial Department, specialising in domestic and international construction and engineering projects for developers, contractors, professionals and project financiers.

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SYNOPSIS

This paper suggests that, despite the advantages for an Employer in procuring a complex building process through a management contracting structure, which involves the placing of a relatively low risk on the Management Contractor, nevertheless there is at least one disadvantage that is not always fully appreciated. This is that, owing to the mechanics of the way in which the provisions of most forms of management contract and related sub-contracts operate to relieve the Management Contractor of the risk of defaults by his Sub-Contractors, the Employer ends up not merely bearing the risk of default or insolvency of the Sub-Contractors, but being in effect possibly debarred from recovering the full extent of his loss and damage from the Management Contractor where this is caused by a Sub-Contractor's breach, even where the Sub-Contractor is solvent.

The paper reviews the Management Contractor's relieving clauses in the 1987 JCT form of Management Contract and in some contractor-generated standard forms of Management Contract. It considers the nature of the risk placed on the Employer through the operation of such relief provisions and the possible discrepancy between the Employer's loss and damage and what he can recover from the Management Contractor - such discrepancy resulting from different degrees of remoteness of damage at the different contractual levels, and/or ineffectiveness of the Sub-Contractor's indemnity to the Management Contractor, and/or damage being contributed to by breaches by more than one Sub-Contractor. The paper then suggests some provisions which attempt to redress the Employer's position while maintaining the relatively low-risk nature of the contract structure for the Management Contractor. Finally, the paper suggests that the generally accepted interpretation of the Management Contractor's relief provisions as expressed in the JCT 1987 form may need rethinking.

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1. The Background

1.1 The perceived rationale for management contracting, as one of many tried and tested contractual structures used for procuring large scale construction works, is broadly twofold.

1.2 First, there are the timing considerations. Liaison with the building Contractor from an early stage in the overall programme for a project enables the Employer to receive fully fleshed out proposals concerning preliminary design, cost estimates and programme estimates, from a design and professional team which includes the Contractor, before the Employer is committed to carrying out the project, while leaving detailed design and tenders from Sub-Contractors for remaining work packages to be completed and finalised in parallel during the construction period. The net result permits commencement of works on site several months earlier than could be achieved using the more traditional methods whereby full design and quantifying is undertaken prior to consideration being given to letting the building contract. By in effect overlapping several stages of the overall design, planning and construction process, completion of a project can be achieved in a timescale that would have been unthinkable using traditional contractual structures, while at the same time giving each activity longer for completion within itself - notably, the detailed design. Consequently, management contracting has become established as a preferred procurement system for so-called "fast track" projects, which is where it had its inception in the early 1970's.

1.3 Secondly, and more significantly for the purposes of this paper, management contracting is seen as enhancing the degree of Contractor involvement in the planning and organisation of a project and as promoting the Contractor to the role of full member of the Employer's team of professional advisers, cooperating and liaising with the other members of the team in producing a coherent and integrated finished product - in particular, by enabling review of the "buildability" of a

projected design at the planning rather than the construction stage. Such early and close involvement, in the capacity of a quasi-consultant, removes from the Management Contractor the adversarial role and claims-conscious attitude prevalent in the contracting industry in traditional forms of contracting. The Management Contractor should be enabled to feel motivated to promote his Employer's interests in common with his own, rather than perceiving himself as pitted against his Employer.

1.4 He is put in this position through two key aspects of the contractual structure; the fact that a management contract will not be a "lump sum" contract but based on cost (against agreed estimates) plus fixed fee; and the placing of a relatively low contractual risk on the Management Contractor, treating him as a professional paid a fee for his services, which he has no opportunity through the operation of the contract to enhance at the expense of the Employer's interest. By placing a low risk on the Management Contractor, his commitment to satisfying his Employer's interests is secured, because he is protected from having continually to look over his shoulder to cover himself against exposure to contractual risks over which he ultimately does not have control - notably defaults by Sub-Contractors.

1.5 It is the object of this paper to suggest that, notwithstanding the admitted advantages resulting from the low risk placed on the Management Contractor in this form of contracting, nevertheless under current forms of management contracting, including possibly the recently published JCT form of Management Contract, the Employer is put in the position of not merely bearing the risk of non-recovery which has been removed from the shoulders of the Management Contractor, but of being virtually certain that the recovery available to him will never equate to the overall loss and damage that could be suffered by him resulting from a breach or default by the Sub-Contractors actually carrying out the work. Apart from any difficulty this may cause the Employer, it may also be a matter of concern for his funders, if they are taking security by way of an assignment of the contract.

1.6 So far as can be determined, there are no reported decisions treating on the effect of the management contract provisions which seek to shift risk from the Management Contractor to the Employer. This

analysis therefore proceeds on the basis of first principles and by reference to analogous cases dealing with remoteness of damage and indemnity.

2. Relieving Provisions for the Management Contractor - the JCT Form

2.1 Let us start by considering various kinds of contractual provisions that are used to relieve the Management Contractor from what would otherwise be his normal risk of total liability for defaults by his Sub-Contractor (which we will call generally "the relief principle"). The general mechanism used by such provisions is to subordinate the Employer's right to recover from his Management Contractor, to the Management Contractor's right - and ability - to recover from his Sub-Contractors.

2.2 The 1987 JCT form of Management Contract (the "JCT form") provides that the Management Contractor:

- is to be "fully liable to the Employer for any breach of the terms of this Contract including any breach occasioned by the breach by any Works Contractor of his obligations under the relevant Works Contract" (Clause 1.7);

- is to "secure the making good of all defects, shrinkages or other faults specified [in the Architect's schedule of defects] but at no cost to the Employer" (Clause 2.5);

- is to "pay or allow to the Employer... a sum... as liquidated and ascertained damages for the period between the Completion Date and the date of Practical Completion of the Project" (Clause 2.10);

- is to comply with Architect's instructions in regard to the removal from the Site of any work, materials or goods which are not in accordance with the Contract "at no cost to the Employer" (Clause 3.11);

- and is to comply or secure compliance with Architect's instructions "requiring any defect, shrinkage or other fault which

shall at any time appear or be discovered and which is due to materials, goods or workmanship not in accordance with this Contract...to be made good...at no cost to the Employer" (Clause 3.12).

2.3 Between them, these provisions cover the core of the Management Contractor's normal obligations to his Employer - responsibility for delay in completing the Works or defects in the Works, and the inability to escape that responsibility (contractually, as opposed to in tort) merely by delegating it to others. However, all the quoted provisions are expressly subjected to Clause 3.21 of the JCT form conditions, which on its terms applies "notwithstanding anything contained elsewhere in this Contract" and "in respect of any breach of, or non-compliance with, a Works Contract by a Works Contractor" - including, also expressly, in the situation of termination for default of the Works Contractor. It thus overrides all the rest of the contract, whether or not particular provisions are expressly subjected to it.

2.4 Clause 3.21 of the JCT form requires the Management Contractor to operate the terms of the Works Contract for dealing with breach or non-compliance by the Works Contractor. This is in order to recover, in effect, both the Management Contractor's own loss and damage (if any) which he sustains resulting from the breach or non-compliance, and that for which the Management Contractor is liable to the Employer as a result of such breach or non-compliance - that is, the Employer's own loss and damage which would be recoverable (ordinarily) as a result of the Management Contractor's breach of his Management Contract, constituted or caused by the Works Contractor's breach of the Works Contract. The Employer then pays to the Management Contractor the latter's costs incurred in pursuing remedies against the Works Contractor (and in undertaking the various other obligations of the Management Contractor under Clause 3.21); he is subsequently able to recover those amounts to the extent, but only to the extent, that the Management Contractor himself recovers them from the Works Contractor in breach.

2.5 A similar provision obtains in respect of liquidated damages which the Employer would ordinarily be entitled to recover from the Management

Contractor if breach by a Works Contractor has put the Management Contractor in delay (breach of a Works Contract being, under the Management Contract, not per se a ground for granting an extension of time to the Management Contractor); the Employer is entitled to keep an account of liquidated damages accruing due to him but can only recover them to the extent that equivalent liquidated damages are recovered by the Management Contractor from the Works Contractor in breach.

2.6 The net effect of this - at least, according to the interpretation of the JCT form as expressed by the JCT official commentary in Practice Note MC/1 and by various other commentators - is perceived to be that a shortfall in amounts recovered by the Management Contractor from the Works Contractor, when compared with the loss and damage suffered by the Employer resulting from that breach, is borne by the Employer rather than the Management Contractor. (See, however, the postscript below for a discussion as to whether this is in fact the case on a strict reading of Clause 3.21.2).

2.7 In other words, the intention of the JCT form is that the Employer can recover his own loss and damage, which (apart from liquidated damages for delayed completion) would need to be proved according to the ordinary contractual rules of remoteness of damage etc., if and only if the Management Contractor can himself recover the same loss and damage - or at least, the same amount of money - in the guise of loss and damage provable, again according to the ordinary rules of remoteness, by the Management Contractor under his contract with the Works Contractor. Thus in order for the Employer to recover, so much of the Management Contractor's own loss and damage as consists of his liability to the Employer for the latter's loss and damage, needs to be recoverable and recovered by the Management Contractor from the Works Contractor either as foreseeable damage or on the basis of an indemnity given by the Works Contractor to the Management Contractor.

2.8 Such an obligation to indemnify is stated in Clause 1.8 of the JCT Works Contract, and what amounts, in effect, to the intended extent of this indemnity is expressed in Clause 1.6.1 of the JCT Works Contract. The latter states that the Works Contractor's liability to the Management Contractor for breach of the Works Contract "shall include,

but shall not be limited to, any liability which the Management Contractor may incur to the Employer under or for breach of the Management Contract by reason of the negligence, act, omission or default of the Works Contractor". In order to deal with the potential bar to relief inherent in chains of contracts of indemnity as opposed to insurance, Clause 1.6.2 of the JCT Works Contract then proceeds to impose an undertaking on the Works Contractor "not to contend, whether in proceedings or otherwise, that the Management Contractor has suffered or incurred no damage, loss or expense or that his liability to the Management Contractor should be in any way reduced or extinguished by reason of Clause 3.21" of the Management Contract. Whether that is effective remains to be seen.

3. The Relief Principle - Other Standard Forms

3.1 Before proceeding to examine the actual effect of these provisions, it may be instructive to compare a few other forms of contractual provision used to achieve the same objective, namely to relieve the Management Contractor by placing on the Employer the risk of a shortfall in recovery from the Works Contractor. The usual source of such provisions is in standard forms of Management Contract developed by the larger contracting companies. Not unnaturally, such forms tend to express the principle of relief for the Contractor and placing of risk on the Employer, rather more explicitly and less obliquely than does the JCT form which in theory is, after all, a compromise reached by all sides of the industry. The following references are to clauses found in forms used by three of the major management contractors.

3.2 One such form expressly, as an overriding principle, limits the Management Contractor's liability to the Employer in respect of sub-contracted matters, to a liability to account for such sums as the Management Contractor recovers from the subcontractor under the subcontract or (to the extent only of the Employer's loss) for its breach or repudiation; and the Management Contractor is to be indemnified by the Employer against loss or expense not recovered from the subcontractor. By contrast with the JCT form, this thus expresses the principle as a limitation on the Management Contractor's liability rather than a restriction on the Employer's remedy. As such, it raises

the question of whether by virtue of S.3 of the Unfair Contract Terms Act 1977, and as the written standard terms of business of one party, it is subject to the reasonableness requirement of the Act. The JCT form, on the other hand, as a form negotiated between all sides of the industry, is generally accepted not (at least if unamended) to constitute either party's "written standard terms of business" for the purposes of the Act.

3.3 Another contractor's form provides that where the Management Contractor is liable to the Employer for breach of the Management Contract by reason of any act or omission of a sub-contractor, the Management Contractor is to take all necessary steps to enforce the terms of the sub-contract etc. and will be reimbursed accordingly by the Employer; and the Employer will not be entitled to recover any sums from the Management Contractor, under the terms of the contract or otherwise, in excess of or prior to the Management Contractor's actual recovery and receipt from the subcontractor by judgment or award, or under a settlement consented to by the Employer. This expresses the principle in a nutshell and places the risk of non-recovery clearly on the Employer. This form goes on to provide also that the Employer is to reimburse any expenditure incurred by the Management Contractor resulting from any act or omission of a sub-contractor and not recovered from the sub-contractor, which places the onus squarely on the Employer of reimbursing the Management Contractor for the Management Contractor's own loss, irrespective of any Employer's loss that is irrecoverable. Clearly the loss sustained by the Management Contractor may in certain circumstances exceed that of the Employer, or at least may come under a different head of damage (as between Management Contractor and Sub-Contractor) than that for which the Employer could recover as against the Management Contractor; the Employer is therefore put in the position of indemnifying the Management Contractor in respect of sums which the Employer may have no right or ability to recoup from anyone (though this may be addressed by a direct Employer/Sub-Contractor agreement).

3.4 Yet another contractor's form sometimes seen expresses the relief principle in a still different way. This imposes the usual obligation on the Management Contractor to enforce a sub-contract, breach of which by the sub-contractor has put the Management Contractor in breach with

the Employer, but then states that the Employer will not, under the Contract or otherwise, be entitled to enforce any right to damages against the Management Contractor in excess or in advance of the Management Contractor's recovery from the sub-contractor. This is thus similar to the previous version, but expressed in terms of a bar on the Employer's entitlement to enforce his rights under the Contract rather than a limitation of his liability or restriction on his remedies. Perhaps this is therefore to be treated as a procedural matter, analogous to the position under the Limitation Acts. If so, it will be subject to the same incidents for the party relying on it - for example as a procedural bar rather than an extinguishing of the cause of action, it will be up to the defendant to plead the point by way of defence.

4. The Nature of the Employer's Risk

4.1 It is not the intent of this paper to explore the ramifications of these various now familiar ways of expressing the relief principle, beyond noting that they can have some rather different legal effects, but to proceed from the basis that they all have at least one thing in common - they place an artificial obstacle in what would otherwise be the unbroken chains of contractual liability going from Employer via Main Contractor to Sub-Contractor and of contractual remedy going the other way. The risk which the management contracting structure intends to place on the shoulders of the Employer is the basic risk of non-recovery due to default by a Sub-Contractor, the party in this structure that actually carries out the work. Such non-recovery, as contemplated, may be due to a number of reasons - inability to quantify or prove damage, inability to justify the time and expense which it would take to pursue recovery to the bitter end, or ultimately and most important, insolvency of the Sub-Contractor. The risk of non-recovery due to such causes is capable of being appreciated and understood by the Employer; it is, after all, no more than the risk he would take if he himself were directly to employ the Sub-Contractor to do the works - either under a traditional form of contracting whereby the whole job is let to one main contractor, or perhaps by a construction management structure in which a number of separate trade contracts are let directly by the Employer,

with a Construction Manager providing coordination and management but without participating in the contractual chain.

4.2 However, by expressing the Employer's right to recover in terms limited to the Management Contractor's right to recover, and actual recovery, from Sub-Contractors, the management contract structure places on the Employer an additional inherent risk that he may not have foreseen and will not be able to quantify or protect against. That is, the risk that the loss and damage suffered by the Employer as a result of a breach of contract by the Management Contractor, which the Employer would ordinarily be able to prove and recover from the Management Contractor, may for a variety of reasons simply exceed that which the Management Contractor is able to prove and therefore entitled to recover from the Sub-Contractor or Sub-Contractors whose breach or breaches of sub-contract have put the Management Contractor in breach of his contract with the Employer.

4.3 In the ordinary course, it makes no difference how many links there are in a contractual chain, provided that what happens at the end of it is within the contemplation of the parties. However, in order to make the sum recovered for breach of the last contract in a chain the measure of damages for a similar breach of contract higher up in the chain, clearly it is necessary that the contracts along the chain connecting them should be the same, with no material variation between them. This was confirmed in Dexters Limited v. Hillcrest Oil Co. (Bradford) Limited [1926] 1 K.B. 348, adopted in Biggin & Co. Limited v. Permanite Limited [1951] 1 K.B. 422. The principle, according to Devlin J. in the latter case, "stems from the broad rule that the damage is to be measured by those consequences of the breach which the parties as reasonable men would, if they had thought about it, have foreseen and accepted as natural and probable".

4.4 In the case of the management contracting chain, not only does the Management Contract interpose and express a specific variation, in the shape of the artificial bar on the Employer's right to recover, but the chain contains the inherent variation that the overall management contract works are necessarily different from individual sub-contract packages of works. The overall management contract works will also in

any event always be more than the sum of all the individual sub-contract packages of works.

4.5 Biggin & Co. Ltd v. Permanite also expresses the principle that, where this reliance on the measure of damage at one contractual level as constituting the measure at the next level amounts to reliance on an indemnity, such an indemnity can operate only once the measure of damage at this first level has actually been established - that is, by the party to be indemnified actually paying out, or being adjudged liable to pay out, to the third party. As expressed by Devlin J.: "The general rule is that a defendant who is required to indemnify a plaintiff against his liability to a third party is entitled to have the existence and precise extent of that liability proved against him in proceedings to which he is a party". Although that decision was reversed in the Court of Appeal, this was on the issue that the extent of the third party liability could be established by reasonable compromise between the party to be indemnified and the third party, to which the indemnifier itself need not necessarily be a party. The reversal did not go to the basic principle, that the existence and precise extent of the liability needs first to be established as an amount, whether reasonable or otherwise, to the tune of which the beneficiary of the indemnity is actually out of pocket.

4.6 There is thus, it is submitted, a significant possibility of discrepancy between what the Employer has suffered by way of loss and damage under the Management Contract and what he is entitled to recover from the Management Contractor, which will be limited to what the Management Contractor is entitled to recover from one or maybe a number of Sub-Contractors. This discrepancy can result separately from, or by the interaction of, three principal fact situations: the operation of different degrees of remoteness of damage at the different contractual levels; ineffectiveness of the Sub-Contractor's indemnity where the Employer's damage is too remote from him; and/or damage being contributed to by breaches by more than one Sub-Contractor.

5. Foreseeability and Remoteness

5.1 In the first situation, the problem for the Employer arises because, as a matter of law, the Management Contractor is not entitled to recover as against the Sub-Contractor loss and damage suffered by the Employer which is too remote from the Sub-Contractor. One can certainly envisage circumstances where matters which would be foreseeable by the Management Contractor - at least under the second limb of the Rule in Hadley v. Baxendale (1854) 9 Ex. 341 - would not be foreseeable by the Sub-Contractor. That this is so, is made clearer by the restatement of the Hadley v. Baxendale principles in Victoria Laundry v. Newman [1949] 2 K.B. 528, in which Asquith L.J enunciated the principle that the test of the extent of liability, or remoteness of damage, is one of reasonable foreseeability, and that what is reasonably foreseeable depends upon knowledge, which may be actual or imputed.

5.2 The actual knowledge of the Management Contractor as to the circumstances in which the Employer lets his building contract, may and almost inevitably will be greater than, or at least different from, the actual knowledge of any one of his Sub-Contractors. The knowledge of the Employer's circumstances reasonably to be imputed to Sub-Contractors may approximate the Managing Contractor's knowledge more or less closely, depending on a number of factors: the extent of the Sub-Contractor's involvement in the planning stage; the proportion of the Sub-Contract works to the works as a whole; and the degree to which the Sub-Contract is drafted so as to attempt to fix the Sub-Contractor with notice of the Employer's circumstances, such as the terms of the agreements under which the Employer derives his interest in the land on which the works are taking place, or the particular uses to which the Employer intends to put the works. However, it is suggested with some confidence that in virtually no case will even the imputed knowledge of a Sub-Contractor be identical with or even approximate the imputed knowledge of the Managing Contractor - not, at the least, without careful drafting and extensive use of "deeming" provisions in the Sub-Contract.

5.3 By way of example: assume an Employer, a speculative developer, who acquires from a local authority the freehold of a dilapidated terrace of town houses with planning permission for redevelopment. The developer

is to add a new storey to each house in the terrace by converting the existing lofts and is to convert each house into two self-contained units of two storeys each. He engages a Management Contractor at an early stage to advise on the development. The Management Contractor is shown the agreement under which the developer acquired the site from the authority, which obliges the developer to observe a number of detailed building requirements set out in a specification scheduled to the agreement. Under the development agreement the developer also undertakes to pay certain amounts to the authority if certain of the units are not occupied by a certain time after practical completion, and to reimburse the authority its costs of providing temporary accommodation for the occupants of Council properties opposite the development while a new access road to serve both is constructed, and for the costs of relandscaping the front gardens of those properties.

5.4 The Management Contractor's employment is continued for the construction phase of the project and practical completion is achieved on time. However, during the defects liability period and before either the new units have been occupied or the properties opposite have been reoccupied, cracks begin to appear in the upper storey walls of the development; the problem is traced to roof spread caused by defective bolts fixing the roof supports which were repositioned in the course of the loft conversions. It takes three months to effect the necessary remedial work, which includes not only replacing all the defective bolts and adjusting the supports that have moved but also disrupting and making good a substantial amount of plumbing, electrical work and insulating material which has to be displaced in order to gain access to the source of the problem. In addition, scaffolding has to be re-erected which delays completion of the access road and landscaping.

5.5 The Sub-Contractor who was responsible for the roof supports and for supplying and fitting the defective bolts (the defect not having been apparent at the time when the work was carried out) had had incorporated into his sub-contract the obligation to comply with the specific building requirements of the authority scheduled to the development agreement, and had been given a copy and fixed with notice of the contents of the schedule. However, he had not seen the rest of the development agreement and was not aware of the additional costs for

which the developer would become liable to the authority in the event of delayed occupation of the developed units and/or delayed readiness for reoccupation of the properties opposite.

5.6 In these circumstances the Management Contractor's breach of his contract is caused by the Sub-Contractor's breach, but the full extent of the developer Employer's damage caused by the breach is within neither the actual nor, it is suggested, the imputed knowledge of the Sub-Contractor. It is therefore too remote to be recovered by the Management Contractor from the Sub-Contractor; the Employer is consequently barred from recovering it at all (in the absence of a direct agreement with the Sub-Contractor).

6. The Sub-Contractor's Indemnity

To get over the remoteness of damage problem, the sub-contract will usually contain a provision such as Clause 1.6.1 of the JCT Form of Works Contract conditions referred to above, which expressly purports to impose on the Sub-Contractor a liability for the Management Contractor's liability to the Employer. This is usually coupled with an indemnity such as that in Clause 1.8 of the JCT Works Contract, which is essentially the same as that in JCT NSC/4 and the NFBTE 'Blue' and 'Green' forms. Even this, however, may not produce the required result.

6.2 Take a variant of the example in section 5 above. Suppose that the Management Contractor in that situation also knows that the developer has a purchaser lined up for a proportion of the finished units which are to be fitted out particularly luxuriously. The special requirements for these units are incorporated in the specifications for the Management Contract and are passed on, as appropriate, to the plumbing and sanitary fittings Sub-Contractor. From general discussions with the developer and the developer's architect, the Management Contractor knows that the developer's prospective purchaser regards this project as something of a trial run for certain other prospective luxury renovations which he has in mind. The Sub-Contractor, being less closely involved in the planning stage, is not aware of this.

6.3 Due to certain defective plumbing fittings, none of the jacuzzis installed in the units operate to the required pressure. The prospective purchaser proceeds with the purchase of the units but is so disappointed with the standard of performance (even though the faults are rectified), that he takes his other prospective transactions elsewhere.

6.4 Assuming that the loss of business opportunity were quantifiable by the developer to a sufficient degree to entitle it at least in theory to recover damages on that account from the Management Contractor, that head of damage would not be recoverable by the Management Contractor from the Sub-Contractor other than on the basis of a widely drawn express indemnity. The indemnity in Clause 1.8 of the JCT Works Contract is indeed broad, but in practice anyone advising sub-contractors required to give such an indemnity must advise them to seek to confine it to the risks which they themselves can quantify on the basis of the information given to them by the Management Contractor; and such an indemnity is sometimes strenuously resisted, or at least cut down, on just these grounds.

6.5 Even where the broad indemnity is accepted by the Sub-Contractor, the interposition of the relief principle in the Management Contract may create a timing problem in enforcing the indemnity. As noted above by reference to the case of Biggin & Co. v. Permanite, the obligation to indemnify another against the amount of a liability incurred by that other to a third party arises in principle only once both the liability to the third party has been incurred and the loss of the party to be indemnified has been ascertained and established - that is, by its actually paying out to the third party under a reasonable compromise or being the subject of a judgement or award for the payment in question.

6.6 In the context of the present discussion, this principle is made the clearer by some more recent cases dealing with the question when the cause of action on an indemnity arises for limitation purposes. In County & District Properties Ltd. v. C. Jenner & Son Ltd [1976] 2 Lloyd's Rep. 728 (also at 3 BLR 41), Swanwick J. found, after a thorough review of earlier authorities which appeared to show conflicting positions at law and in equity, "that the general rule in cases of

indemnity is that while equity will safeguard the position pending the ascertainment of the fact and extent of liability of the person to be indemnified, he has no cause of action until such ascertainment. There is thus a strong body of authority not only in favour of" the... "proposition as to when the cause of action for an indemnity arises at common law as modified by equity but also to the effect that these rules...are universal." The indemnity in that case was Clause 3(b) of the NFBTE 'Green' form contract - one of the forerunners of JCT Works Contract Clause 1.8. That clause was specifically found to constitute an indemnity not against a liability arising but against the sustaining of ascertained and established loss resulting from the liability.

6.7 Because of the previously conflicting authorities, particularly Bosma v. Larsen [1966] 1 Lloyd's Rep. 22, there was some doubt as to whether County & District Properties Ltd. was rightly decided. That doubt was resolved in 1980 in R. & H. Green & Silley Weir Ltd v. British Railways Board [1985] 1 All ER 237 (also at 17 BLR 97), where Dillon J. preferred Swanwick J's approach and held that the cause of action does not accrue until ascertainment of the liability, where (as is the case with the JCT form) the indemnity is not against liabilities arising but against payment and determination of the liabilities. Both County & District Properties and R & H Green & Silley Weir have subsequently been followed in a number of cases at first instance, including Telfair Shipping Corp v. Inersea Carriers [1985] 1 All ER 243 (Neill J.) and Grand Bahama Petroleum Co. Ltd v. Manunited Companiera Naviera SA 1985 Commercial Court Unrep. (Leggatt J.); they have also been cited with approval in the Court of Appeal - Gromal (UK) Ltd v. W T Shipping Ltd 1984 C.A. Unrep. (Slade L.J.).

6.8 Under the normal management contract structure, as exemplified in the JCT and other clauses along the lines of the examples given above, there must therefore be a risk that the indemnity given by the Sub-Contractor to the Management Contractor against liability to the Employer, such as that in JCT Works Contract Clause 1.8, will never bite at all. This is because the absolute bar to the Employer's recovery from the Management Contractor will operate to prevent the Management Contractor ever sustaining an actual loss against which to be indemnified - the Management Contractor's cause of action on the Sub-

Contractor's indemnity will never arise, because actual recovery by the Employer is effectively a precondition to it.

6.9 It is submitted that this particular vicious circle is not in fact effectively broken into by a provision such as Clause 1.6.2 of the JCT Works Contract, as referred to above in paragraph 2.7. By this clause the Works Contractor undertakes not to contend that the Management Contractor has incurred no damage etc. by reason of Clause 3.21 of the Management Contract, the relieving provision. The problem is that the matter will never reach a stage where the Sub-Contractor is put to making such a contention by reference to the relieving provision; the Management Contractor will be unable to show any ascertained and established damage against which to be indemnified, so that his cause of action will never arise.

7. Multiplicity of Sub-Contractors

7.1 There is a third situation, as referred to above, where a discrepancy can arise between what the Employer has suffered by reason of a breach of the Management Contract and what he will be able to recover via the Management Contractor from the Sub-Contractors. This is where, as is likely to happen frequently in practice, the Management Contractor's breach is in fact constituted by the interaction of breaches by a number of trades. It may be that the Management Contractor is unable to ascribe a particular problem to one or more particular Sub-Contractors; or that it is not possible to quantify the Management Contractor's or the Employer's damage flowing individually from each contributory breach by a number of Sub-Contractors; or simply that each Sub-Contractor who is potentially involved in the claim seeks to disclaim liability and pass it on to the others. Whatever the circumstances, there has to be an appreciable risk that the sum of such recovery as the Management Contractor is able to make from the Sub-Contractors concerned, and irrespective of any rights of contribution they may have between themselves, will not equal the totality of the loss and damage which the Employer can prove to have resulted from the Management Contractor's breach of his contract and which he would ordinarily be able to recover if he were simply looking at the Management Contractor and no further. This can be made still more

difficult where outside contractors directly engaged by the Employer are also involved.

7.2 To suggest another example: suppose the Employer is a securities and investment house relocating its main dealing operations to a new building under construction, in which the Employer intends to take a number of floors on long lease. It engages a Management Contractor to advise on and subsequently to procure the fitting out of its new premises. This includes both certain structural works left by the landlord to its tenant to complete under the agreement for lease with a contribution from the landlord to the cost, and also the full fitting out of the dealing floors ready to receive the computing, communications and information processing equipment without which the Employer's core dealing activities cannot function. Assume that this equipment is to be supplied and installed under a sub-contract let by the Management Contractor (though in practice it is frequently supplied direct to the Employer, which compounds the problem).

7.3 A few months after the Employer goes into occupation of its new premises, a substantial part of its dealing system goes down and the back-up system fails to operate for 48 hours. The information systems equipment supplier blames the cabling sub-contractor, who blames the air conditioning sub-contractor, who blames the Management Contractor's sub-contracted mechanical and electrical consultant, who blames the Management Contractor's sub-contracted information technology systems consultant. The problem is eventually ascribed to a peculiar combination of inadequate specifications between the two sub-consultants of the precise interface requirements between the cabling and the equipment, and a quirk in the air conditioning installation which does not totally meet the requirements of the specification but which was passed as satisfactory and would not have caused a problem but for the difficulty with the cabling/equipment interface. Furthermore, it is claimed that the basic loss to the Employer, of his trading operations for 48 hours, would not have been occasioned, or at the very least was aggravated, by the failure of the Employer's computer maintenance contractor to perform; the maintenance contractor claims that, on the terms of the maintenance agreement, consequential loss to the Employer as a result of failure to provide maintenance was clearly excluded.

7.4 In this situation the Management Contractor is able to recover from its sub-contractors and sub-consultants, and therefore pass on to the Employer, only to the extent that it can prove actual breach of contract by any of them. In the circumstances this is possible only against the air conditioning sub-contractor, whose minor departure from the specification had been passed by the Management Contractor reasonably and not in circumstances that amounted to negligence on the Management Contractor's part. The Employer's loss of business for the time the system is down therefore goes unrecovered.

8. The Management Contractor's Position

8.1 Of course, the Management Contractor's own risk is not entirely excluded. Clause 3.21.3 of the JCT form deals with the position where the Management Contractor is not reimbursed by deduction from the Works Contractor who is in breach of his Works Contract, in respect of a claim which the Management Contractor has to meet from another Works Contractor resulting from the first Works Contractor's breach. In this situation the Management Contractor must first seek to recover his own shortfall in reimbursement from the Works Contractor in breach, "through arbitration or litigation if necessary". The Management Contractor can only look to the Employer for reimbursement of the shortfall if he is not fully reimbursed "despite compliance by the Management Contractor with the terms of Clause 3.21.3", which presumably means he has to pursue any arbitration or litigation so far as is possible, before falling back on his claim on the Employer.

8.2 Similarly, under Clause 3.22, if a Works Contractor makes a claim against the Management Contractor for alleged breach of the Works Contract, the Management Contractor must settle or defend the claim in arbitration or litigation and pay out any amount, including costs, ordered against him. The Management Contractor is then reimbursed by the Employer only if the Management Contractor was not himself in breach or negligent, and only after the Management Contractor has himself paid out to the Works Contractor. The Management Contractor may thus incur significant expense, and may have to make available an appreciable

amount of management time, some considerable while before he can expect to be recompensed for it.

8.3 The Employers' position is thus alleviated at least to the extent of not having to shoulder the Management Contractor's risk in these areas until the risk has finally materialised and has been definitively quantified. For a supposedly low risk contract, from the Management Contractor's point of view, there is still an appreciable risk left with him; he is therefore likely to be all the more resistant to any solutions to the Employer's problems which seek materially to increase this risk - at least, not without being given the opportunity to enhance his fee, which would change the whole basis for the contractual structure.

9. Balancing of Interests - Suggested Clause

9.1 The examples above demonstrate something of the artificiality of the position in which the Employer is put by the operation of the relief principle, in having the risk of a shortfall in recovery which he could not have anticipated but which the Managing Contractor could. On the other hand, the Employer has to accept that the advantages which the management contract structure will bring will not accrue if the whole of this risk is simply sought to be returned to the Management Contractor. Overall, the objective as always must be to strike an equitable balance. This must maintain the Management Contractor's avoidance of risk for the effects of breaches by Sub-Contractors over which he has no control, including in particular the inability to recover due to insolvency of a Sub-Contractor; at the same time it must preserve for the Employer the right to look to the Management Contractor (as the equivalent of a main contractor in the traditional sense) to make good foreseeable loss and damage which the Employer has suffered and which he would have been able to recover from the Sub-Contractors (assuming their solvency) had they been directly contracted to him.

9.2 It is suggested that the way to attempt this balance is not to dispense entirely with the bar on the Employer's right to recover from the Management Contractor in respect of breaches by Sub-Contractors, but carefully to limit the extent to which that bar operates, with a view to

ensuring that it will only apply in appropriate circumstances. To this end, a provision can be framed to express the relief principle which draws on the JCT and other examples quoted earlier, but seeks greater flexibility. Something along the following lines is proposed:

"1. The Management Contractor shall be fully liable to the Employer for any breach of or non-compliance with the terms of this Agreement including without limitation, but in this case subject always to Clause 2, any breach or non-compliance which is caused wholly or partly by the breach or non-compliance by any Sub-Contractor of or with its obligations under a Sub-Contract. The rights and remedies of the Employer provided for in this Agreement are cumulative and not intended to exclude any rights or remedies provided by law whether for breach of contract, breach of any duty owed by the Management Contractor or otherwise. The Employer is relying and shall be deemed to have relied exclusively on the skill and judgement of the Management Contractor in all matters within the scope of the Management Contractor's obligations under this Agreement.

"2. If and to the extent that:

2.1 the Employer has suffered or incurred loss, damage or expense and the Management Contractor is liable to the Employer for the same by reason of a breach of or non-compliance with any express obligation of the Management Contractor under this Agreement; and

2.2 such breach or non-compliance, and the Employer's loss or damage resulting from it, is demonstrably and directly caused wholly or partly by the breach or non-compliance by any Sub-Contractor of or with its corresponding express obligation under a Sub-Contract (other than a breach or non-compliance consisting of a failure by the Sub-Contractor to execute any collateral deed of warranty in favour of the Employer required by or pursuant to this Agreement and/or the relevant Sub-Contract); and

2.3 that Sub-Contractor's liability for its breach or non-compliance to the Management Contractor, in respect of which the Management Contractor is entitled to and does recover

from the Sub-Contractor, includes the Employer's loss, damage or expense for which the Management Contractor is liable to the Employer;

then and to such extent the provisions of Clause 3 shall apply and the Management Contractor's liability to the Employer referred to in Clause 1 shall be qualified accordingly.

"3. If and to the extent that the conditions of Clause 2 are satisfied, then:

3.1 The Management Contractor shall in consultation with the Employer take all necessary steps:

3.1.1 to operate the terms of the Sub-Contract for dealing with such breach or non-compliance, including action or arbitration if necessary to secure the performance of the same and to recover damages in respect of any loss, damage or expense directly or indirectly suffered or incurred by the Management Contractor and/or by the Employer caused by such breach or non compliance;

3.1.2 to secure the satisfactory completion of the Works including the engagement of a further Sub-Contractor for the sub-contract package in question; and

3.1.3 to meet any claims by other Sub-Contractors properly made under their respective sub-contracts, in respect of the consequences to them of the breach or non-compliance in question.

3.2 The Employer shall not be entitled to recover from the Management Contractor, whether under the terms of this agreement or by set-off or action or otherwise, any sums (including without limitation liquidated and ascertained damages payable by the Management Contractor under Clause...):

3.2.1 in excess of such sums (including without limitation liquidated and ascertained damages due under the Sub-Contract) if any, as the Management Contractor shall have recovered and received from such Sub-Contractor by set-off or deduction or judgement or

arbitration award or by agreement with the Employer's consent; or

3.2.2 before recovery and receipt by the Management Contractor of such sums.

3.3 Any expenditure properly incurred by the Management Contractors in taking the steps referred to in Clause 3.1 and which is not recovered from the Sub-Contractor shall be reimbursed to the Management Contractor by the Employer, except to the extent that such expenditure is caused by any negligence of the Management Contractor or of any other Sub-Contractor from whom the Management Contractor is entitled to recover such expenditure."

9.3 The aim of such a provision, by comparison with the examples quoted earlier, is to clarify the following:

- All the relieving provisions of paragraph 3 operate only to the extent that paragraph 2 is satisfied. Thus, they are effective only to the extent that the Management Contractor's liability arises under an express term of the Management Contract; any other lines of recovery that the Employer may have against the Management Contractor remain unqualified, and the cumulative remedies provision reinforces this. (Admittedly, though, following the House of Lords' recent decision in the D & F Estates case it must be recognised that recovery of pure economic loss in tort will not in any event be available.)
- A clear relationship has to be established between the Management Contractor's breach of its contract with the Employer and the Sub-Contractor's breach of its Sub-Contract; the Management Contractor's liability is only qualified to the extent that such relationship is established. Consequently any liability which the Management Contractor otherwise owes to the Employer, which is not covered by a clearly definable liability of the Sub-Contractor, should remain recoverable by the Employer from the Management Contractor.
- The relief principle will not defeat the Employer's right to recover from the Management Contractor where the latter has an insufficient indemnity from the Sub-Contractor or is unable for some reason to rely on the indemnity.

- As a separate issue, the Employer at all events is entitled to receive any collateral warranties for which he has stipulated from the Sub-Contractor. If the Sub-Contractor in breach of its Sub-Contract refuses to give these, that remains a risk for the Management Contractor.

- The Employer is not liable for the Management Contractor's costs of proceeding against Sub-Contractors to the extent that the necessity of so proceeding is referable to the Management Contractor's own fault.

- The Management Contractor is still relieved of risk and responsibility where it is unable to recover from a Sub-Contractor due to the latter's insolvency or where it settles with the Sub-Contractor with the Employer's agreement.

9.4 Such a provision is not necessarily a perfect solution - that is probably unattainable. Nevertheless it is suggested that it could achieve a more harmonious reconciliation of the conflicting interests of the Employer and the Management Contractor. This is particularly so in situations where, as in the examples given above, the Employer has suffered loss which is partly attributable to a failure in organisation (which falls short of negligence or breach of contract) by the Management Contractor and partly to a clear breach by a Sub-Contractor. Here, the onus is put on the Management Contractor of justifying, according to the circumstances as they arise, both the right to operate and the extent to which it should be entitled to operate the relief principle. All this, of course, is in addition to the need to give consideration to the Sub-Contractor's indemnity, which should be framed so as to cover the Management Contractor's liability to the Employer as soon as it arises and not only when ascertained and established through recovery by the Employer.

10. Postscript - alternative interpretation of JCT form

10.1 So far as this paper relates to the provisions of the JCT 1987 form of Management Contract, it has been based on the assumption that JCT Practice Note MC/1 and various other commentators on the JCT form are correct in their interpretation of Clause 3.21, which holds it to have the same effect as the rather more explicitly stated relief provisions

in the contractor-generated standard forms referred to above. This interpretation is expressed in JCT Practice Note MC/1 as follows : "The Management Contractor is obliged to seek from the Works Contractor in default all the costs that have resulted from that default including the amounts incurred by the Employer; and the Management Contractor is bound to pay to the Employer what damages he has obtained from the defaulting Works Contractor but if there is any shortfall between these damages and what the Employer has incurred **that shortfall is borne by the Employer not the Management Contractor**" (JCT emphasis). It is suggested, however, that there may be an alternative interpretation of Clause 3.21 based on a close reading of the text.

10.2 In the first place, although the various provisions in the JCT form quoted in section 2 of this paper express themselves as "subject to Clause 3.21" - in particular Clause 1.7 which confirms the principle of the Management Contractor's liability to the Employer "for any breach of the terms of this Contract including any breach occasioned by the breach by any Works Contractor of his obligations under the relevant Works Contract" - nevertheless Clause 3.21 itself does not in terms apply itself to a breach of contract <u>by the Management Contractor</u> occasioned by the breach by a Works Contractor of a Works Contract. Clause 3.21 by its preamble applies simply "in respect of any breach of or non-compliance with a Works Contract by a Works Contractor". Taken on its own this might be construed as the setting of certain procedural steps to be followed in the event of a Works Contractor's breach rather than as establishing a restriction on the Management Contractor's liability, if any, flowing from that breach. Despite the introductory words of Clause 3.21, "notwithstanding anything contained elsewhere in this Contract", it requires the implication of an unstated term, to arrive at the conclusion that Clause 3.21 is an <u>exhaustive</u> statement of the Employer's rights against the Management Contractor in any situation connected with breach by a Works Contractor.

10.3 Clause 3.21.1 proceeds to list the steps which the Management Contractor is to take, "in respect of" a Works Contractor's breach. Clause 3.21.2 then sets out certain items which the Employer has to pay and/or may be entitled to recover from the Management Contractor - again, "in respect of" a Works Contractor's breach. Clause

3.21.2.3 is the crux: "The Employer shall be entitled to recover from the Management Contractor all amounts paid or credited to the Management Contractor under Clause 3.21.2.1 and where relevant the amount of liquidated and ascertained damages referred to in Clause 3.21.2.2 but only to the extent that such amounts have been recovered by the Management Contractor from the Works Contractor who is in breach...". The amounts "paid or credited to" the Management Contractor under Clause 3.21.2.1 are "all amounts properly incurred by the Management Contractor in fulfilling the obligations set out in Clauses 3.21.1.1 and 3.21.1.2".

10.4 Granted, the obligation of the Management Contractor in Clause 3.21.1.1 is to enforce the Works Contract to obtain "any amount due to the Management Contractor including therein any amount for which the Management Contractor is liable to the Employer under Clause 1.7, as a result of the breach or non-compliance by the Works Contractor". However, an "amount due" to the Management Contractor, which it has an obligation under Clause 3.21.1.1 to seek to recover, can hardly be said to be an amount "incurred by" the Management Contractor in fulfilling that self-same obligation for the purpose of Clause 3.21.2.1. Such amounts therefore cannot, it is suggested, be amounts in respect of which the Employer's entitlement to recovery from the Management Contractor under Clause 3.21.2.3 is limited by the words "only to the extent that such amounts have been recovered by the Management Contractor from the Works Contractor who is in breach".

10.5 The only other specific amount in respect of which the Employer's entitlement to recovery is so limited under Clause 3.21.2.3, is that of "liquidated and ascertained damages referred to in Clause 3.21.2.2" - to wit, the normal liquidated damages due under Clauses 2.10 and 2.11 for delay. Nowhere in Clause 3.21.2.3 or, it is thought, elsewhere in Clause 3.21 or in any other provision of the JCT form, is there any express restriction on the Employer's right to recover general damages for breach by the Management Contractor even where that breach is occasioned by the breach of a Works Contract by a Works Contractor. (Clause 3.21.3, which requires the Employer to pay the Management Contractor the amount of certain shortfalls in reimbursement, is limited to situations where the Management Contractor has to meet claims by one Works Contractor in respect of breaches by another.) This is in fact

in marked contrast to the contractor-generated provisions referred to above, which are considerably more specific in their statement of the relief principle; for example, one of them expressly describes what the Employer is not entitled to recover from the Managing Contractor, as being any sums in excess of what the Managing Contractor receives.

10.6 On the basis of this suggested interpretation of the JCT form, perhaps the Employer's position is not as disadvantageous as has been painted above. Actually, the JCT form so interpreted would seem to be quite an effective compromise of the conflicting interests along the lines suggested above, in limiting the bar on the Employer's recovery only to, first, the Managing Contractor's costs incurred in pursuing Works Contractors which the Employer has had to reimburse to the Managing Contractor, and, second, liquidated damages for delay. However, even if this is the result that has after all been achieved, it would seem to be so by accident rather than by design on the part of the JCT.

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