Due diligence, obligations to cooperate and limitations of liability – the importance of ensuring that they are in clear and certain terms

Introduction

The recent judgment by Stuart-Smith J in SABIC UK Petrochemicals Ltd v Punj Lloyd Ltd [2013] EWHC 2916 (TCC) and a related case involving Punj Lloyd’s subsidiary Simon Carves Ltd addressed the following issues, among others:

- the meaning of “due diligence” in the context of clauses obliging a party to carry out works with due diligence, and permitting the other party to terminate if it failed to do so;
- the question of whether there was an implied obligation on one party not to hinder or disrupt the due or expeditious progress of the works by the other party;
- the scope of a clause limiting the liability of the party found to be in breach of contract, and the extent to which that clause applied to costs incurred by the “innocent” party following termination of the contract; and
- the extent to which amounts recovered under performance guarantees/bonds should be brought into account for the purposes of applying the limitation of liability.

The judgment has lessons for all those involved in negotiating or administering construction contracts and professional services contracts.

Key facts:

SCL failed to meet the date for completion stipulated in the contract. This led to SABIC terminating the contract and appointing others to complete the works.

SCL went into administration in 2011 and SABIC sued PLL under the PCG for damages and recovery of costs that it incurred in completing the works.

SABIC also called an Advance Payment Guarantee and a Performance Guarantee which had been provided by SCL under the terms of the contract.

For further information please contact

Tom Pemberton
Partner
T: +44 (0) 20 7420 8682
E: t.pemberton@beale-law.com
Background

In 2006 SABIC UK Petrochemicals Ltd (SABIC) entered into an EPC contract with Simon Carves Ltd (SCL), a subsidiary of Punj Lloyd Ltd (PLL), whereby SCL was to construct a low density polyethylene plant. PLL provided a parent company guarantee (PCG) to SABIC guaranteeing the performance of SCL under the contract.

SCL failed to meet the date for completion stipulated in the contract. This led to SABIC terminating the contract and appointing others to complete the works.

SCL went into administration in 2011 and SABIC sued PLL under the PCG for damages and recovery of costs that it incurred in completing the works. SABIC also called an Advance Payment Guarantee and a Performance Guarantee which had been provided by SCL under the terms of the contract.

Meaning of “due diligence”

SABIC terminated the EPC contract on the basis of a clause that permitted it to do so if SCL failed to comply with its obligation to carry out the works with “due diligence”. SABIC argued that SCL’s obligation to exercise due diligence must be assessed by reference to its other obligations, in particular its obligation to meet certain key dates under the contract. In *Ampurias Nu Homes Holdings v Telford Homes [2012] Ch 1820 (Ch)* Roth J had stated that the concept of due diligence in construction contracts goes further than just due care and “usually connotes both due care and “due assiduity/expedition.”

Stuart-Smith J considered other previous case-law relating to the meaning of “due diligence” and concluded that “what is “due” diligence will depend upon the object to which the obligation attaches”. Where there is an obligation to exercise due diligence, the object to which it attaches must be carried out “industriously, assiduously, efficiently and expeditiously”. He added that just because an obligation becomes incapable of performance does not mean that it should be ‘emptied of content’ and the obligation to exercise due diligence should then attach to the nearest possible approximation of the relevant obligation.
The actual requirements in relation to an obligation to exercise “due diligence” will depend in each case on the terms of the contract in question and the objects to which the obligation to exercise due diligence attaches, but the judgment expands on the guidance provided in the [Ampurius](#) case.

Professionals and contractors should note that when agreeing a “due diligence” obligation in their contracts, it connotes something greater than just due care.

**Repudiatory Breach**

In the alternative, SABIC also argued that SCL was in repudiatory breach because it had failed to mitigate the delays arising. A repudiatory breach is a serious breach of contract whereby a reasonable person would consider the party in default to have refused to accept its obligations under the contract. In such a case the innocent party may either accept the repudiation or affirm the contract. The judgment stated that while SCL’s “failure to exercise due diligence was persistent and serious, mere delay – even when substantial – is not necessarily to be equated with a renunciation of the defaulting party’s side of the contract”.

In the [Ampurius](#) case, the court of first instance had considered a considerable delay to be repudiatory, however, that judgment was reversed by the Court of Appeal ([Telford Homes (Creekside) Ltd v Ampurius Nu Homes Holdings Ltd [2013] EWCA Civ 577](#)) on the basis that the relevant delay was not serious enough to be repudiatory.

While the question of whether a delay is significant enough to be repudiatory is to be answered by taking into account the facts of a particular case, the Court of Appeal’s decision in the [Ampurius](#) case and the TCC’s decision in this case both make it clear that a “mere” delay, even if substantial, is unlikely to qualify as a repudiatory breach.

**Implied obligations in a commercial contract**

SCL argued that SABIC had an implied obligation not to hinder or disrupt the due or expeditious progress of the works and that SCL’s obligation to exercise due diligence was dependant on SABIC’s cooperation.

Stuart-Smith J applied the principle that where a detailed contract has been negotiated, the court should not imply a term into the contract unless it is
satisfied that the term is necessary or it is otherwise obviously what the parties would have understood or intended. In this case, the contract contained detailed provisions requiring collaboration for specific purposes and Stuart-Smith J concluded that there was no need to imply a further general obligation as stated above and contended for by SCL.

When negotiating a detailed contract, parties should ensure that any term that they wish to be included in the contract is expressly set out in the contract and not left to be implied.

**Limitation of liability – not as effective as it appears?**

In a section of the judgment which deserves to attract particular attention, Stuart-Smith J considered whether the following limitation of liability applied to the costs incurred by SABIC in completing the works following termination of the contract:

"the aggregate liability of the Contractor under or in connection with the Contract (whether or not as a result of the Contractor's negligence and whether in contract, tort, or otherwise at law) … shall not exceed 20% (twenty per cent) of the sum of the Contract Price" (Emphasis added)

On a detailed analysis of the above clause in the context of the contract as a whole, Stuart-Smith J held that the parties did not intend the cap to apply to the costs incurred by SABIC in completing the works, notwithstanding the very wide (and typical) wording of the capping clause which limited SCL's aggregate liability "under or in connection with the Contract". While the judgment on this point is strictly obiter, because it did not affect the amount of the judgment sum (which was within the 20% cap however it was held to apply) this judgment is a reminder that caps on liability are construed against those relying on them, increasing the risk of judgments apparently at variance with the plain language of the clause in question.
This is consistent with the following classic formulation by Lord Hoffman in the House of Lords judgment in *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1997]:

“The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean...”

The lesson for contracts draftsmen is that very clear and specific wording should be used if it is intended to limit liability for costs and losses arising from termination (together with any other events and circumstances which are specifically agreed to be included in the cap, e.g. insolvency).

**Effect of monies paid under bonds on the calculation of recoverable losses**

While again not relevant to the outcome of the case due to the court’s judgment on quantum which was within the 20% cap however it was held to apply, the court also provided obiter guidance on the treatment of monies paid out under the Advance Payment Guarantee and the Performance Guarantee (each of which was in effect an on demand bond).

SCL argued that the bond monies should be brought into account once the amount recoverable by SABIC had been reduced by the limitation of liability.

Stuart-Smith J disagreed and stated that the monies paid out under the bonds should be treated as reducing SABIC’s loss and should be deducted from the amount recoverable by SABIC for completing the works before the cap on liability is applied. The effect would therefore be that SCL (and PLL under the PCG) would be liable to SABIC for its losses up to 20% of the Contract Price and in addition would be liable to the Bondsman up to the value of the Bond, assuming that SCL and PLL had provided counter-indemnities to the Bondsman in the usual way. This part of the judgment will be regarded as counter-intuitive to many involved in negotiating caps on liability, and is a reminder that the courts will apply caps on liability as narrowly as possible following the rule that they should be construed against those relying on them.
Stuart-Smith J was influenced by the fact that both the Advance Payment Guarantee and the Performance Guarantee were both expressed to be “on demand” instruments which he compared with promissory notes intended as readily accessible funds to reduce SABIC’s immediate losses. Had the Performance Guarantee been in traditional “default” terms, it is possible (but by no means certain) that he would have reached a different conclusion at least as regards the amounts recovered under that Guarantee.

The lesson for contracts draftsmen from this part of the judgment is that a cap on liability should specifically address the issue of recovery under any bonds, guarantees (including parent company guarantees) and indeed collateral warranties and other ancillary contracts if it is intended that the cap should cover all such instruments.

November 2013

For further information please contact

Tom Pemberton
Partner
T: +44 (0) 20 7469 0416
E: t.pemberton@beale-law.com