



CONSTRUCTION LAW UPDATE – No. 701

Downlight causes fire

Introduction

In November 2006 the NSW Court of Appeal handed down its decision in the appeal against an award of damages for breach of a subcontract.

Stuart Pty Ltd had entered into a head contract with the Commonwealth for the replacement of insulation in 71 houses as part of the Sydney Aircraft Noise Insulation Program (SANIP). Stuart intended to subcontract all of its work to Condor Commercial Insulation Pty Ltd. Stuart and Condor held discussions prior to the commencement of the works in which Stuart told Condor that the project was likely to be "a goldmine" for them both given the large number of homes that were yet to be allocated to contractors. Stuart was hopeful of winning further contracts based on its performance under the first head contract.

The head contract required Stuart to replace in 71 houses the existing wool insulation which had become infested with beetles. When replacing the insulation, Stuart was to install boxes around any downlights to prevent the new insulation coming into contact with the downlights.

When preparing for the works to be performed on each house, representatives from Stuart, Condor and SANIP jointly inspected the home to scope the works. A purchase order was then prepared by Stuart and issued to Condor.

The terms of each purchase order referred only to one of the homes and formed an entire subcontract between Stuart and Condor, although the parties proposed to subcontract all 71 homes to Condor through a series of purchase orders.

On 27 February 1999, Condor commenced work on the first house. During the inspection of the home none of the parties noticed five existing downlights in the bathroom. No boxes were installed around the downlights when the insulation was installed. On 27 July 1999, the new insulation ignited adjacent to the downlights and the resulting fire caused extensive damage to the home.

SANIP commenced an investigation into the work carried out by Stuart, and found that no boxes had been

installed around the downlights. Stuart's contract with SANIP was cancelled.

Stuart claimed against Condor for the loss of profits that it suffered as a result of cancellation of the head contract caused by the defective workmanship that had been carried out by Condor in omitting to box the downlights.

Stuart claimed that the cancellation of the contract had caused it a loss of profits on a further 54 homes it expected to be allocated by SANIP, equating to an amount of \$313,200. Given that the subcontract price for the relevant home was less than \$10,000, it is apparent that Stuart had negotiated a particularly lucrative arrangement.

There appears to have been no dispute that Stuart was liable to the home owner for the defective workmanship and was able to pass that liability on to Condor. However, the issue that came before the court was the claim by Stuart for its loss of profits.

Damages for contract breach

Generally, a party who breaches a contract is liable to pay damages to the innocent party, sufficient to put the innocent party into the same position that it would have been, had the contract not been breached.

If this general principle was applied to the Stuart claim, it might be said that, had Condor placed the boxes around the downlights, Stuart would have been able to complete the other 54 homes and obtain its expected profits.

In 1854, in *Hadley v Baxendale* the English courts placed a limitation on this general principle. The court said that in order for compensation to be payable for a breach of contract, the loss that flows from the breach of contract must have been a loss that flowed naturally from the breach, or was in the reasonable contemplation of the parties at the time they entered into the contract as the probable result of the breach.

More recently, in *Baltic Shipping v Dillon*, Brennan J in the High Court of Australia summarised the principle in the following terms:

The crucial question is whether, on the information available to the defendant when the contract was made, he should, or the reasonable man in his position would, have realised that such loss was sufficiently likely to result from the breach of contract to make it proper to hold that the loss followed naturally from the breach or that loss of that kind should have been within his contemplation.

The court applied these principles to the claim by Stuart for its loss of profits.

Is insulation likely to ignite?

The expert witnesses gave evidence that insulation is generally unlikely to ignite. They said that the expected result of placing insulation over a downlight without boxing around the light would be repeated failures of the downlight or the associated transformer. They said that if insulation was subject to intense heat, it was more likely to shrink away from the heat source than to cause the spread of a fire.

Did Condor know of the lucrative nature of the head contract?

The court found that the discussion between Condor and Stuart, in which reference was made to the "goldmine" the contracts would provide, was not sufficient notice to Condor of the lucrative nature of the head contract. Condor had not been provided with the terms of the head contract. It would not have been within its reasonable contemplation that Stuart would suffer such losses from a breach of the terms of the contract.

Findings

The court said that there were two separate reasons Condor was not liable for the loss of profits.

Firstly, the extent of the profits to be made by Stuart was not known by Condor. It was therefore impossible that Condor would have contemplated that a breach of contract would result in such a loss to Stuart.

Secondly, it was apparent that the loss of profit was not a likely outcome of the breach of contract. This finding was based on the expert evidence that the insulation was unlikely to ignite and that the catastrophic fire leading to the cancellation of the contract was therefore an unlikely event.

The court said that the damage which flowed directly from the fire was foreseeable and that Condor's liability for the direct damage was clearly established.

Conclusion

The general principles for recovering damages for breach of contract in Australia as set out in *Hadley v Baxendale* and *Baltic Shipping* remain unchanged. When entering into a contract, parties should carefully consider the likely consequences of any breach and make a determination as to their exposure.

Liability for the payment of damages for breach of contract can be limited by the express terms of the contract.

Where a head contractor seeks to pass liability for loss of profits on to a subcontractor, the terms of the subcontract should expressly say so.

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