



CONSTRUCTION LAW UPDATE No. 704

Co-operative contracts and estimated cost blowouts

A recent NSW Court of Appeal decision as to an architect's responsibility for cost overruns on a cost plus contract is applicable to all forms of co-operative contracting where advice is provided on an estimated cost and the works are completed on a cost plus basis.

The initial budget - \$90,000

Mr & Mrs McKenzie consulted with an architect, Mr Miller, in relation to renovations and extensions to a Californian bungalow in rural NSW. The McKenzies indicated their budget was \$90,000. Miller told the McKenzies that the budget was inadequate for the scope of work proposed.

The estimate - \$205,000

Notwithstanding this observation, the parties continued discussions and the next day Miller wrote to the McKenzies attaching his terms of retainer and suggesting that he design the extensions and the parties could then reconsider the budget and the designs. Miller used the RAI A short form Client/Architect Agreement. A few weeks later, Miller wrote again enclosing an initial design. He stated that his estimate of the order of costs was a "Total Budget requirement, about \$205,000".

Although this was more than double the initial budget proposed by the McKenzies, they elected not to make savings that were suggested by Miller and essentially agreed to proceed with the initial design.

The lump sum contract

Miller told the McKenzies that a cost plus contract was appropriate. He said that they would obtain much better value by this means than by using a lump sum contract. He said that a builder quoting on the project on a lump sum basis would add a substantial margin to account for the risks involved in extending an existing home.

In September 2001, the plans were submitted for Council approval and Miller confirmed an estimated construction budget of \$202,000.

Miller suggested some builders to the McKenzies but recommended in particular Mr David Chase. Chase agreed with Miller's recommendation as to the cost plus contract as he said the final cost was difficult to assess due to the possibility of

difficulties with the existing house and the site restrictions arising from the layout of the block. After discussions, a cost plus contract was agreed between Chase and the McKenzies.

When the first progress claim was received on 19 January 2002, the McKenzies noticed that the demolition and site preparation works had cost 55% more than estimated by Miller. Mrs McKenzie gave evidence that Miller was dismissive of her concerns about this overrun.

The cost blow out - \$285,000

Cost overruns continued and in April 2002 at the insistence of the McKenzies, Miller provided an updated cost for completion whereby he estimated the completion cost at \$280,000 to \$285,000. The McKenzies did not immediately respond to this news and Miller wrote again seeking directions as to whether they could afford to continue with the works.

In his response, he said that his "initial estimates were given before documentation was implemented. On analysis, these estimates were optimistically low and incomplete and did not include for contingencies for special site conditions, neighbours, scaffolding, delays, etc., which have become a major cost component."

The McKenzies were "deeply shocked" by the cost blowout, pointing out that their initial budget was \$90,000.

There was ongoing debate between the McKenzies and Miller as to the financial role of the architect in a cost plus contract. Miller said that his role was to achieve a building of the desired quality at the best possible price as the agent of the McKenzies and that in his view, they had approved of every major decision, although wishing that it had cost less.

The final cost - \$326,928

The project was ultimately completed at a cost of \$305,220.33 but given that deletions were made, the true completed cost of the designed works was \$326,928.

The proceedings commence

The McKenzies claimed that they would not have commenced the project if they had known of the final completion cost. They issued proceedings in the District Court of New South Wales seeking compensation from Miller for breach of contract, negligence and for breaches of the *Fair Trading Act 1987*. The District Court dismissed their claim. The McKenzies appealed to the Court of Appeal.

The breach of contract

In relation to the breach of the retainer agreement, the Court noted that the agreement between Miller and the McKenzies required Miller to "review opinions for probable construction cost" at the time of contract documentation stage. The agreement required Miller to exercise reasonable skill and care in performing his services.

Miller said that he was not obliged to carry out the review of probable costs at the contract documentation stage because the McKenzies had negotiated a cost plus contract. The Court rejected that submission.

The Court noted that Miller had confirmed the budget at the time the plans were submitted to Council, indicating that he had in fact been in possession of all the necessary documentation to arrive at the final construction cost.

The Court noted that the agreement required Miller to inform the McKenzies within a reasonable time if he "had reason to believe that the authorised expenditure...was likely to be varied significantly".

Estimated budgets for construction works are often relied upon by the principal even where the estimator has not carefully prepared the budget.

Negligence and breach of the *Fair Trading Act 1987*

These breaches of the agreement were clear indicators to the Court of a breach of Miller's duty of care to the McKenzies.

Finally, the representation by Miller that the total costs of the work would be \$202,000, as set out in his estimate at the time of Council approval, was found to be a continuing representation. He had not corrected that estimate until the subsequent letter of April 2002, by which time the McKenzies had committed to the project. The representation was misleading and deceptive conduct for the purposes of the *Fair Trading Act 1987*.

The matter was remitted to the District Court for an assessment of damages.

Conclusion

The construction industry has seen a growing trend towards co-operative contracting, such as cost plus contracting or management contracting. In these contracts, a cost estimate is normally prepared as an indication of the total project cost.

Estimated budgets for construction works are often relied upon by the principal even where the estimator regards the budget as indicative only. Intention in preparing the budget is not relevant when a dispute arises as to the accuracy of the estimate.

In order to confine disputes of this nature, it would be prudent to clearly define the nature and extent of the duties of the estimator by describing the purpose of the estimate.

However, the terms of the *Fair Trading Act 1987*, and the *Trade Practices Act 1974* relating to misleading and deceptive conduct cannot be excluded by any contract.

Parties should exercise care when providing estimates and include appropriate contingency sums where there is uncertainty as to the quantum of the estimate or monitor costs during the construction phase and keep the principal informed of overruns.

Contributor: Tom Grace

Tom is a former engineer who ran his own construction company for 20 years before becoming a construction lawyer. He has wide experience in the engineering and construction fields and specialises in the resolution of commercial disputes.

Contact Details

Tom Grace – Partner
Direct: (08) 8110 8004
tom.grace@feg.com.au

April 2007

This publication is not legal advice. It is for general interest. You should not rely on it without obtaining legal advice.

Fenwick Elliott Grace is a law firm that specialises in providing legal services to the construction and engineering industries.

Office: Level 10, Optus Centre
431 King William Street
ADELAIDE SA 5000

Ph: (08) 8110 8000
Fax: (08) 8231 2922
Web: feg.com.au

If you would like to receive our legal publications by email, please contact Amanda Atkins on (08) 8110 8000 or by email at amanda.atkins@feg.com.au.