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Cutoffs and Setoffs – Navigating Liability Caps and Setoff Provisions in Commercial Contracts

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Financial caps on liability and the right to setoff are common clauses in project documents, particularly within goods-and-services agreements and construction contracts. Understanding the interaction between these clauses is crucial for industry participants, to manage risks and ensure commercial certainty effectively. This note provides a summary of the case law and drafting tips for businesses.

By way of background:

- A financial cap on liability serves to limit the amount of money that a party is liable to pay to the other party. This mechanism mitigates potential financial exposure and provides a degree of certainty in the event of a dispute.
- A setoff clause entitles parties to apply any debts they are owed against any payments due to the other party such that only the net amount (if any) will be payable. This arrangement simplifies debt recovery and is, therefore, a common feature in project documents.

Occasionally, there are questions about the order in which the two should be applied. UK and Australian law both indicate that this question is ultimately answerable by construing the terms of the agreement in a commercial manner.

The English High Court has recently given us helpful guidance in *Topalsson GmbH v Rolls-Royce Motor Cars Ltd [2023] EWHC 1765 (TCC)*. The situation was a common one. In short, the supplier was found to have failed to supply specialised software under the sales agreement to the purchaser, which, on that basis, rightfully terminated the agreement. The purchaser incurred additional costs and suffered other losses totalling approximately €8 million. The supplier was found to be owed around €800,000 for services performed before the termination. The agreement contained both setoff and cap-on-liability provisions as follows:

- **Clause 14.8** – “The Purchaser shall be entitled to set off any Charges due to the Supplier under this Agreement against any amount owed by the Supplier to the Purchaser under this Agreement.”
- **Clause 20** – “The total liability of either Party to the other under this Agreement shall be limited in aggregate for all claims no matter how arising to the amount of €5m (five million euros).”

Among other things, the court was asked to determine whether the €5 million cap applied before or after the supplier’s setoff for sums owned at termination. If the cap was applied before any setoff, the purchaser could recover €4.2 million (i.e. €5 million minus €800,000). If the cap was applied after the setoff was made, the purchaser could recover damages up to the €5 million cap. The court found that the overall liability cap applied once the setoff was made as the cap on liability applied to the “total liability of either party to the other in aggregate for all claims no matter how arising”. In contrast, Denning MR in *Tojo Maru (No.1)* [1969] 2 Lloyd’s Rep 193 found that the cap applied before the setoff because the limitation on liability was expressed as applicable to any article that was damaged or lost. Therefore, the cap was to be applied separately to each article damaged or lost.

Similarly, in Australia, the question of whether the cap applies before or after setoff turns on the terms of the agreement. The leading authority is *Global Constructions Australia Pty Ltd (in liq) v AIG Australia Ltd [2018] FCA 98*. In this case, Global Constructions Australia Pty Ltd (Global Constructions) made a claim under a policy issued by the insurer for “Direct Financial Loss” caused by “Fraudulent Acts” by a shareholder. The contract provided as follows,

“Section 4

Clause 6 Shareholders

The Insurer shall pay the Direct Financial Loss of any Insured Entity resulting from Theft or Fraudulent Acts of any person who owns or controls any of the Insured Entity’s issued share capital. If such person owns or control more than 5% of the Insured Entity’s issued share capital, then the Insurer’s liability for Direct Financial Loss shall be reduced by:

- (i) any amount owed to such person by the Insured Entity; and
- (ii) the financial value of such person’s share in the Insured Entity as determined by an independent valuation of such share as at the date such Theft or Fraudulent Act is first Discovered.

...

General Terms & Conditions

Clause 1 Limit of Liability

...

If the Schedule specifies a ‘Limit of Liability’ or ‘Sub-Limit’ for each policy ... Each such Limit of Liability is the aggregate limit of the Insurer’s liability with respect to all Loss arising under such policy Section, other than with respect to Policy Section 1 – Management Liability Cover 4 ‘Reinstatement Limit’.

...

The Insurer shall have no further liability in excess of all such limits, irrespective of the number of Insureds or amount of any Loss or Direct Financial Loss, including with respect to any Claim as specified in General Terms & Conditions Claims Condition 4 ‘Related Direct Financial Loss’.

(Limit of Liability is defined as the sum specified in the policy schedule, where Crime Protection has a sub-limit of \$500,000)“

The loan account plus the value of shares was over AU\$800,000, while the liability limit was AU\$500,000. However:

- Global Constructions claimed that the loan account and value of the shares (i.e. the setoff) are deducted from the Direct Financial Loss first, and, to the extent that the remainder exceeded the liability limit of AU\$500,000, the insurer’s obligation was capped at AU\$500,000.
- The insurer claimed that the liability limit of AU\$500,000 ought to be applied first before setting it off with the loan account and value of the shares, reducing liability to AU\$0.

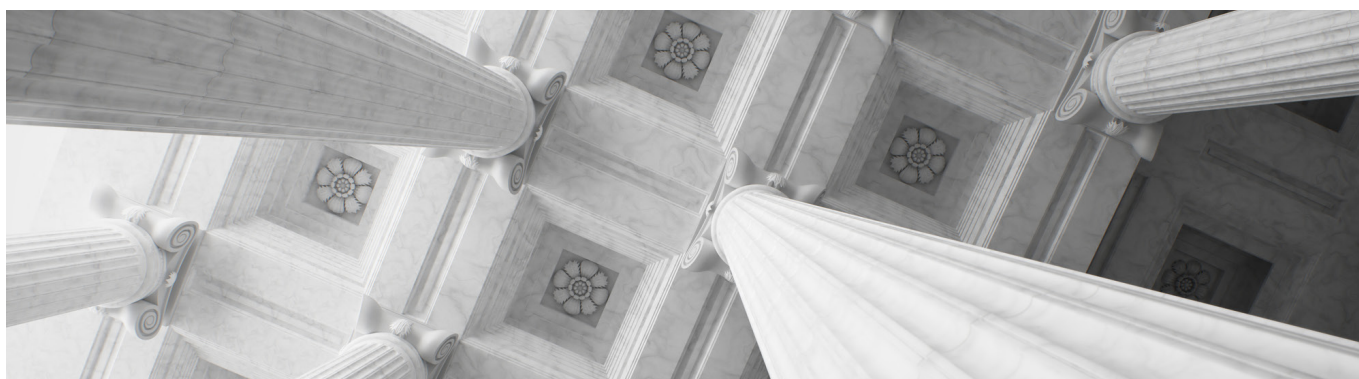
The court held that it is necessary to give the contract “a businesslike interpretation with attention to the language used by the parties, the commercial circumstances which the document addresses and the object which it is intended to secure.” The court also placed weight on the location of the liability cap and setoff clause in the document:

- Section 4 lists the six types of “cover” for which an insured can make a claim, one of them being “Employee Fraud or Dishonesty” and the other being “Shareholders”
- In a separate section after Section 6, “General Terms and Conditions,” the liability cap can be found.

As a result, the court considered that the limit of liability was a cap on the liability of the insurer to the insured, calculated pursuant to the requirements of the relevant part of Section 4. It is a limit on liability, and not definition of the liability itself. This interpretation is consistent with its location in the policy in a separate section. The court further held that adopting the insurer’s view would transform the limit of liability into a provision that was part of the insuring clause, which does not make commercial sense. The court, therefore, determined that the shareholder’s loan account and shares value were to be set off against the direct financial loss prior to the application of the liability cap.

These findings, however, are fact specific and may not apply to all contracts. Ultimately, the court must follow the process of construction to determine the appropriate order to apply any rights to setoff and limits on liability. For the industry participant, it is imperative to employ precise language and careful structuring to articulate the intent and mechanics of each contractual provision. It is important that the contract is clear on whether the cap is a cap on liability or whether it forms part of the liability itself.

Given the scope and complexity of the issues that may arise, it is prudent to obtain legal advice on proposed limitation caps and setoff provisions to reduce the risk of contractual disputes and potential financial loss.



Contract Models – Offshore Wind Farms

A discussion on contracting structures for the delivery stage of Australian offshore wind power infrastructure

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Legal Regime Regulating Offshore Wind Farms

The offshore wind development regime in Australia is nascent. The overarching legislation, the Offshore Electricity Infrastructure Act 2021 (Commonwealth), and associated regulations began operation in June 2022. The regime allows licence holders to conduct offshore infrastructure activities within Commonwealth offshore areas. For closer-in state and territory waters, separate state and territory laws apply.

The initial licence that is required for offshore wind developments is a feasibility licence. The federal government, through the Department of Climate Change, Energy, the Environment and Water, has prepared a guideline on the feasibility licence process for activities involving fixed or tethered infrastructure for offshore wind power. A commercial licence is required before the wind farm infrastructure can be constructed, installed, commissioned or operated.

The requirements for a feasibility licence include the provision of a comprehensive project development plan identifying key risks and uncertainties and how they are to be addressed.

The feasibility licence process is competitive. As stated in the guideline, an applicant with a clear pathway to finalising commercial agreements, including evidence of agreements to be negotiated, would be assessed as having higher merit than a person with a general understanding of the relevant commercial agreements to resolve the risks and uncertainties and other project viability issues.

So, it would be advantageous for an applicant for a feasibility licence, and essential for an applicant for a commercial licence, to have a clear understanding of the contractual regime for the delivery of the project.

This article will briefly explore the contractual challenges and options for investors and developers in constructing, installing and commissioning offshore wind power infrastructure during the delivery phase.



Contracting Structures

There is no standard form of contracting structure for delivering offshore wind projects.

Standard forms such as FIDIC, NEC, LOGIC and BIMCO have been used and modified for aspects of these projects under a traditional model, although bespoke agreements abound.

From European experience, there continues to be a move away from the traditional model of a single engineer, procure and construct (EPC)¹ contract into split EPC contracting and multicontracting models, and a greater willingness to consider alternative models.

The splitting of the overall works has arisen for various reasons. The complexity of offshore projects and the desire for fixed pricing and scheduling can produce a high-risk profile for an EPC contractor taking on the entirety of the work. This risk profile can attract a risk premium payable by the developer. The industry is also categorised by a limited group of specialist contractors that carry a relatively strong bargaining position in contract negotiations.

The split-contracting approach has sometimes led to a disaggregated contracting model comprising a small number of separate EPC/EPCI contracts. These separate contracts may be for:

- Turbine design, supply, installation, commissioning and maintenance
- Civil works, array and electricity cable supply and installation (sometimes known as balance of plant)
- Substation construction, supply and installation

Developers seeking to have more control over the development of the offshore wind infrastructure and to reduce the high-risk premium may take a next-level, multicontracting approach by having many smaller contracting packages for distinct areas of supply and work. The developer would then (itself or by engaging an external project manager) project manage these packages, taking on the interface risk. However, some measure of sharing of the interface risk with the contractors sometimes occurs.

For example, in the multicontracting approach, the supply and works packages may take the form of standalone agreements between the developer and different specialist contractors for each of:

- Turbine design
- Turbine supply
- Turbine transportation and installation
- Civil and foundation works
- Array/electricity cable supply
- Array/electricity cable installation
- Substation construction
- Substation supply
- Substation installation
- Infrastructure maintenance

Benefits and Drawbacks of Each Structure

Each EPC/EPCI(C) and multicontracting structure has its own benefits and drawbacks for the developer. A developer should consider its own capabilities, risk profile and requirements of financiers when deciding on which contracting structure to use.

EPC/EPCI

An EPC/EPCI structure results in fewer contact points and more interface risk passed onto the turnkey contractors. However, this structure often results in higher costs and increased execution risk as some contractors venture into areas that are not their core competency.

Ensuring risk is appropriately spread across the developer and contractors is also an important consideration, particularly when contractors are operating as more of a “generalist” rather than in specialised fields.

From a contract drafting perspective, negotiating and implementing matching “boilerplate” terms and milestones across these contracts to ensure consistency across contractors is also a less demanding task.

Multicontracting

A multicontracting approach allows the developer greater control over each distinct aspect of the project, with specialised contractors being used at potentially lower cost. Risk is also spread to contractors specialising in a certain task, potentially lowering risk premiums embedded in the price paid to contractors. However, the multicontracting approach may result in greater execution risk for the developer because the risk is spread across various disciplines.

Multicontracting requires closer attention from the developer to deliver the complete infrastructure package by managing milestones, timing and other execution aspects. As such, the multicontracting approach is more likely to be assumed by larger and more experienced developers.

¹ Sometimes called EPCI or EPIC contracts in the wind farm context.

Alternative Contracting Models

Hybrids of the traditional contracting models and cooperative contracting models are gaining increasing attention.

When moving away from the traditional models, the shifts in risk allocation and the mechanisms to motivate the contractors need to be carefully considered. The developer will need to understand how it will successfully manage the extra risk it has accepted. Incentives for contractors can come from several mechanisms, such as in pricing structures and target incentives.

Cooperative contracting models such as ECI and alliancing may be attractive where the project is complex, and the risks are uncertain and need to be shared. The choice of cooperation model will depend on the circumstances of each project as well as the relationship of the parties and the approach they each wish to take.

If alliancing is chosen, the alliance may be between the developer and the primary contractors. Whether the alliance might flow through to lower-tier contracts should be considered.

It may be that cooperative packaging of the work is the best model; for example, an alliance contract to cover some aspects and an incentive or fixed fee arrangement for other aspects.

Unique Aspects of Offshore Wind Construction Contracts

Aside from the contracting structure the developer must choose, there are also contractual issues that are particular to offshore wind power infrastructure that are required to be considered, although offshore oil and gas industry experience means many of the offshore wind farm risks (such as logistics and technology) are not unique.

Special treatment for weather events is typically given in the risk allocation of contracts relating to the performance of offshore work. Weather impacts on installation timeframes can cause damage to infrastructure and potentially have other knock-on consequences that should be considered when drafting relevant contracts.

Sea conditions, adverse weather and interface issues can have a significant impact on the availability of installation vessels.

Further, the unique installation procedures for offshore wind power infrastructure should also be considered; namely, whether the turbines are to be fixed, tethered or floating. Each type of installation poses its own execution risks.

Technology is developing rapidly in this respect, and there may be higher risks of defects for relatively new technology. Contract drafters should consider how:

- Defects will be managed and remedied
- Delays will be dealt with
- Parties allocate financial responsibility for defects and/or delays

Finally, since several of the designated areas for Australian offshore power infrastructure are some distance from shore, accommodation and protection of personnel should also be a consideration for project developers. In particular, contract drafters will need to consider the health and safety risks of undertaking installation works in deep waters and potentially dangerous weather conditions.

Offshore transmission infrastructure requires its own individual considerations.

In summary, while the allocation of interface risk and certain other contracting risks in offshore wind energy infrastructure projects will depend on the chosen contracting structure, the key contracting risks are those typical of most construction projects. However, the extent of those risks is exaggerated by the logistics and technological aspects of these projects. Careful consideration of all aspects of the contracting regime is called for.



Toolbox Topics

Levelling the Playing Field – Prohibiting Unfair Contract Terms in Australia

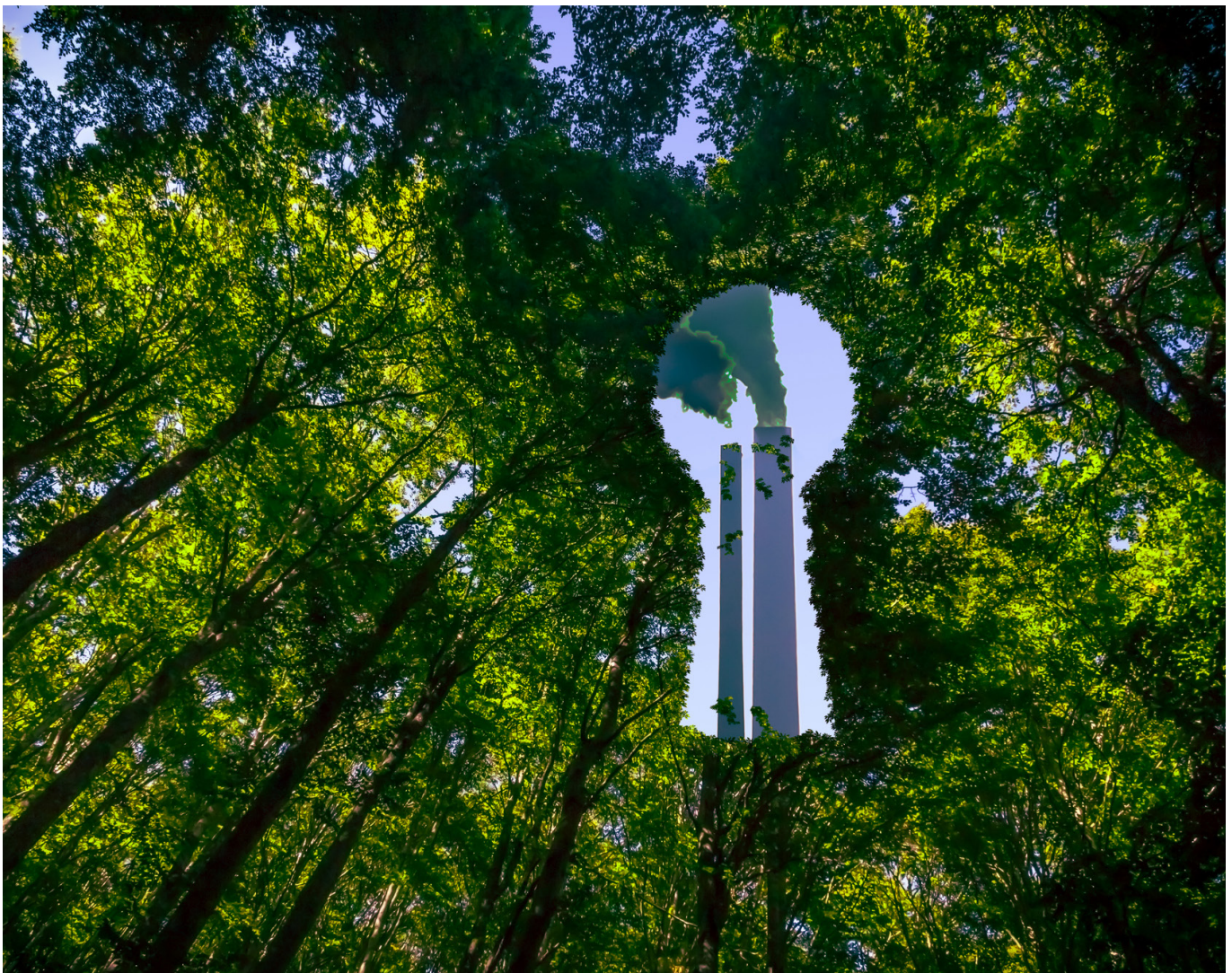
This is a reminder that a significant change is on the horizon for companies using standard form contracts in Australia. New unfair contract terms (UCT) reform is set to take effect from 9 November 2023, ushering in a pivotal shift in the contracting landscape. The reform aims to bolster consumer and small business protection by curbing UTC, ensuring a fairer playing field for all parties. Companies should carefully review and potentially amend their standard contracts to ensure compliance with the upcoming changes and avoid the risk of hefty penalties under the Australian Consumer Law (ACL).

Why the Construction Industry Needs to Be Worried About “Greenwashing”

It is reported that, globally, the construction industry is responsible for almost 25% of greenhouse gas emissions, 40% of total energy production, 16% of total water consumption and 30% to 40% of all solid waste. Growing environmental awareness and activism means it is likely that industries with a large carbon footprint and environmental impact, such as the construction industry, will face increasing scrutiny of their “green” claims. Managing the risk of greenwashing is challenging and complex. While at its core, it is a matter of “doing what you say you are doing, or are going to do,” in practice, it is far from that simple.

Closing Loopholes Bill – Regulating Labour Hire

Earlier this year, we foreshadowed the swift approach of the Albanese government’s “same job same pay” measures. On 4 September 2023, the federal government introduced the Fair Work Legislation Amendment (Closing Loopholes) Bill 2023, with one of the proposed amendments to the Fair Work Act 2009 (Cth) aimed at enabling labour hire employees to be paid at least the same as their directly employed counterparts who are performing the same work and paid under the host’s enterprise agreement. In this article, we unloop the proposed “closing the labour hire loophole” measures.



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