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Alliance contracts glimpse of the future

Doug Jones

In the last few years a host of new delivery structures has been developed for construction and engineering projects. Each has offered different allocations of cost, time and design risks.

In the right circumstances, two of the newest structures — design, construct and maintain - and alliance contracting - can offer considerable advantages over traditional project delivery and the more common design and construct (D&C), managing contractor and construction management delivery structures. In particular, they can more effectively reduce disputation.

Unlike partnering, whose rhetoric is often not matched by contracts that still use adversarial risk allocations, these two structures use hard construction contracting issues to provide a financial incentive for cooperation. And, best of all, they can often be combined very productively.

Alliance contracts

The motivations for an alliance

As everyone is painfully aware, traditional D&C lump sum construction contracts have become breeding grounds for disputes because the financial interests of the owner and the contractor are fundamentally opposed.

While alternatives involving fee-for-service remuneration, such as EPCM, reduce this adversarial relationship, they provide much less scope for the construction manager to be held responsible for substandard performance. Alliance contracting is an attempt to strike a balance between these two extremes.

An alliance is simply a long-term relationship between two or more entities pursuing mutual goals. To give this alliance the best possible chance of success, it is essential to give the contractor performance-based remuneration so that its financial interests and those of the owner become more closely aligned and it is in both parties' financial interests to cooperate. At the same time, the contractor is left with enough risk to motivated it to put its best team on the job. Importantly, in alliance contracting, the hard contractual issues of risk allocations and remuneration which directly affects the parties' bottom lines are used to encourage cooperation. This is in stark contrast to partnering, which, in Australia,

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> suffers from the misconception that the only escape from adversarial contracting is to focus on the *soft* issues such as the building of personal relationships and the matching of corporate cultures.

For example, the release of the NSW Department of Public Works and Services' new C21 contract was accompanied by rhetoric about seeking to change the culture of the construction industry by promoting co-operative contracting and partnering. But C21 is actually quite traditional in its risk allocations. Its inherently adversarial structure is quite inconsistent with the department's stated objectives.

Like any other delivery structure, alliance contracting has its limitations.

A lump sum contract is still the best way to deliver most one-off construction projects. And it is not enough for an owner to think an alliance is appropriate: the contractors must see it as strategically advantageous as well.

But alliance contracting comes to the fore with long-term contractual relationships. Especially when:

- at the outset, the owner cannot specify its need clearly enough for a lump sum tender to be made;
- the contractor is reluctant to put a firm price tag on the longterm risks;
- the owner needs flexible access to the contractor's resources.

A typical example is a contract for the maintenance of capital assets such as buildings, infrastructure and equipment.

In Australia, alliance contracting has been adopted by Rail Access Corporation for the design, construction and maintenance of all NSW rail infrastructure, and by Ampolex and BHP, among others.

Its advantages are:

- easier achievement of best practice benchmarks;
- · easier resolution of differences

of opinion;

- through long-term familiarity with the owner's operations, an ability by the contractor to offer expert advice as well as construction, engineering or maintenance services;
- lower contract administration costs:
- lower costs in developing performance-based standards, compared with the costs of developing prescriptive scopes of work;
- avoidance of the high cost premium normally associated with the outsourcing of risks;
- a greater ability to vary the scope of work;
- a greater ability by the owner to focus on its core business.
 The main difficulties are:
- a lack of local industry skills in operating in uncertain conditions where the scope of work cannot be fully prescribed; and
- the shallowness of the market, given the need for service providers to have substantial financial standing.

Alliance contracting is not suitable for everyone. The potential to share advantages can come at the price of increased project costs. Parties must find a comfortable risk allocation formula for that scenario. For this reason, alliancing may prove difficult for the public sector to embrace given the accepted process for spending public funds involving open competitive tendering against prescriptive contract conditions (unlike the flexibility found in most alliance contracts).

Some alliance contracting issues

The selection of a partner is the first critical step. Expressions of interest can be used to assess financial and technical criteria, the contractor's culture, its

preparedness to risk its overheads and profit, its willingness to share information freely and to undertake internal partnering and dispute resolution initiatives.

An owner can use functional specifications and performance-based remuneration to achieve competitive results and to enable service providers to devise innovative solutions to its problems. Prescriptive scopes of work are not only difficult to specify for long-term relationships but will dissuade may service providers.

Remuneration structures must combine contract accountability with financial incentives for both parties to co-operate, so many alliances use hybrids with lump sum, reimbursable and fee components. Some of the contractor's remuneration must be at risk against the achievement of the performance indicators.

Gainshare/painshare arrangements are common. In one example, all the participants have put their entire corporate overhead and gross profit margins at risk against the achievement of agreed project costs objectives for both the construction and operation phases. If the project comes in at less than the target costs, all the participants generate extraordinary profits. Cost overruns are shared by all participants, including the owner, up to a cap fixed at each participant's gross margin, with any further cost overruns being borne by the owner.

Although the contractor's ability can be a contentious issue, there is no reason why it should not be liable for those risks that are clearly within its control. What must be guarded against are unreasonable attempts by an owner, exploiting a superior bargaining position, to place as much risk on the contractor as it can. This is counter-productive because it elicits defensive responses

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Case Notes

RE COSSLETT (CONTRACTORS) LTD

Court of Appeal, Evans, Millett LJJ and Sir Ralph Gibson, [1997] 4 All ER 115

The English Court of Appeal in the decision of Re Cosslett (Contractors) Ltd dealt with a number of significant issues impacting upon construction contracts, most notably the effect of express provisions in contracts governing the ownership, as between principal and contractor, of plant and materials on site as well as the nature of rights granted under the contract to principals where contractors have abandoned the works. The decision also makes some salient points with respect to drafting 'vesting' and 'seizure' clauses which should be of interest to practitioners.

Facts

Cosslett (Contractors) Ltd (the contractor) was contracted by Mid-Glamorgan County Council (the principal) to undertake engineering works in a land reclamation scheme, part of which involved the processing of large volumes of coal-bearing shale. In the course of the works, two coal-washing plants were established on the site. Under cl 53(2) of the contract, all plant, goods and materials owned by the contractor, while on site, were deemed to belong to the council as employer. Further, cl 53(7) provided that the plant and materials were to revest in the contractor on completion of the works or previous removal from the site. Clause 54 made provision for the transfer of property in goods and materials to the council prior to delivery to the site in order to secure payment and cl 63(1)

provided that if the contractor went into liquidation or abandoned the contract, the council could enter onto the site and either use the plant and materials which were deemed to belong to it under cls 53 and 54 to complete the works, or at any time sell such plant or materials and apply the proceeds towards the satisfaction of any sums due from the contractor under the contract.

After encountering financial difficulties and before the works were completed, the contractor abandoned the site, leaving the coal-washing plants behind. When the council refused to comply with the contractor's administrator's demand to deliver up the plants or pay for their use, the administrator applied to the court for an order requiring delivery up of the plant under s 234 of the Insolvency Act 1986, contending that the council's contractual rights as employer gave it a proprietary interest in the plant which amounted to an equitable security interest in the nature of a floating charge registrable under s 395 of Companies Act 1985 (s 395 provides '... a charge created by a company is ... void against the liquidator [or administrator] ... unless the prescribed particulars of the charge are delivered to ... the registrar ... for registration ...). Further, since no floating charge had been registered, the council's contractual right to retain the coalwashing plants was void as against the administrator. Jonathan Parker J dismissed the administrator's claim, holding that the contract conditions created an equitable proprietary interest in the nature of a specific charge and not a floating charge, so the council's rights were unaffected by the lack of registration.

Issues

The issues before the Court of Appeal were as follows:

- (a) whether cl 53(2) of the contract had the effect of transferring the legal property to the council;
- (b) if it did not, whether the council's right to retain possession of the plant and to use it to complete the works constituted an equitable charge;
- (c) whether the council's power of sale arose by way of possessory lien or equitable charge;
- (d) if either right arose by way of charge, whether the charge was a fixed or floating charge;
- (e) if so, what were the consequences of the contractor's failure to register it.

Did cl 53(2) transfer legal property in the plant to the council?

The first issue to be considered by the Court of Appeal was whether cl 53(2) of the contract had the effect of transferring the legal property in the plant to the council. If this question was answered in the affirmative, then when delivery up was demanded the property of the plant would still be with the council and there would be no scope for the existence of any charge.

Jonathan Parker J, at first instance, held that in the context of the contract as a whole the expression 'be deemed to be the property of in cl 53(2) meant that legal ownership was not to pass, but that the parties agreed to proceed for the purposes of the contract as if it had. Central to this conclusion was the contrast between the 'deeming' provision in cl 53(2) and the

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> corresponding 'deemed' revesting provision in cl 53(7) with the clear language employed by the draftsman in cl 54. Accordingly, Jonathan Parker J found the property in the plant which was brought onto the site remained with the contractor, subject to the council's contractual right under cl 63(1) to use the plant to complete the works and to sell it and apply the proceeds of sale in or towards satisfaction of any sums due or which may become due to it from the contractor.

The Court of Appeal agreed with the conclusion of Jonathan Parker J and held that on its true construction, cl 53(2) did not pass legal ownership in the coalwashing plants to the council. The court recognised that the question of legal ownership depended on the terms of the contract and it was essentially a question of contractual construction. It was held that where the purported vesting clause used may be regarded as ambiguous (such as in the present case where the contractor provided the plant and materials 'shall be deemed to be the property of the principal') reference may be had to other provisions as well as to the whole purpose and scope of the contract to ascertain whether the parties intended to vest the materials with the employer.

The court identified a number of indicia pointing to the conclusion that legal ownership of the plant and materials brought onto the site did not pass to the council. First, under cl 53(6), the contractor was prohibited from removing plant or materials from the site without the consent of the engineer (this clause would be unnecessary if the plant and materials belonged to the council). Secondly, under cl 53(9), the council was exempted from liability for loss of or injury to plant or materials brought onto the site. This provision was also inconsistent with the property having passed to the council. Millett LJ placed less weight on cl 53(9) given the fact that the contract contained a revesting clause (cl 53(7)).

Finally, the court found that the last sentence of cl 53(2) was of particular persuasive force. It applied the vesting clause both to plant belonging to the contractor and to plant belonging to its controlled subsidiaries. As Millet LJ observed:

In relation to plant which belongs to a subsidiary, the clause is effective in equity as a deeming provision, for the court could order specific performance of the contract by requiring the contractor to exercise its powers of control over the subsidiary and thus procure compliance with its own contractual obligations. But the clause cannot possibly operate at law to pass title to property owned by a company not a party to the contract.

Accordingly, the council's submission that at the time the administrator made his demand for delivery up, legal ownership in the plant had been transferred to the council, was rejected.

Did the council's right to retain possession of the plant and use it to complete the works constitute an equitable charge?

The Court of Appeal held that the council's right to retain possession of the plant and use it to complete the works did not constitute an equitable charge. This conclusion was reached for primarily two reasons. First, the Court of Appeal considered that the right to use the plant to complete the works did not give the council a proprietary interest in the plant but only rights of possession and use. It was held by Millett LJ that:

It is of the essence of a charge that a particular asset or class of assets is appropriated to the satisfaction of a debt or other obligation of the chargor or a third party, so that the chargee is entitled to look to the asset and its proceeds for the discharge of the liability. This right creates a transmissible interest in the asset. A mere right to retain possession of an asset and to make use of it for a particular purpose does not create such an interest and does not constitute a charge.

The second fundamental reason for the court's finding that the right of the council to retain possession of the plant and use it to complete the works did not constitute an equitable charge was that it was not given by way of security and hence could not be described as a security interest. Millett LJ was of the opinion that the right given to the council did not secure the performance of the contract by the contractor but was provided for the purpose of enabling the council to perform the contract in its place. Accordingly, the council's contractual right to retain possession of the plant and materials and use them to complete the works did not constitute a security interest and did not require registration.

It followed from the above conclusion that since at the date that the writ was issued the works had not been completed, the council's right to retain possession of the plant was sufficient to defeat the administrator's claim.

Did the council's power of sale arise by way of possessory lien or equitable charge?

A further submission was that the council acquired possession of the plants, coupled with a contractual power of sale under cl 63(1), which entitled them to assert a

<u>conclustion</u>

> possessory lien in answer to the administrator's demand for delivery up. It was held by the court that cl 63(1) did not constitute a possessory lien with a power of sale since the council's rights in relation to the plant were exclusively contractual and not attributable to any delivery of possession by the contractor. This conclusion was reached on the basis that when the contractor brought plant and materials onto the site they remained in possession of the contractor to enable it to use them in the completion of the works. When the council expelled the contractor from the site the council came into possession of the plant and materials left behind. This power was derived and exercised by the council as a contractual right to take possession of the plant and materials and was not a voluntary delivery of possession by the contractor.

The Court of Appeal concluded that the council's power to sell the plant and apply the proceeds in or towards discharge of the various sums which might be or become due from the contractor by reason of its failure to complete the works was clearly a security interest. Accordingly, it was held that the council's rights derived from contract were conferred by way of security and constituted an equitable charge.

Is the charge a fixed or floating charge?

The next issue to be decided was whether the charge constituted a fixed or floating charge. Romer LJ in *Re Yorkshire Woolcombers*Association Ltd (1903) 2 Ch 284 (at 295) stated that if a charge has the following three characteristics then it is a floating charge:

• it is a charge on a class of assets of a company present and future;

- that class is one that which in the ordinary course of the business the company would be changing from time to time;
- it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way so far as concerns the particular class of assets subject to the charge.

'... by forbidding the contractor from removing from the site plant or materials required ... for the completion of the works, the council was imposing a restriction on the way in which the contractor carried on its business.'

Jonathan Parker J reached the conclusion that the equitable charge created by cls 53 and 63 was not a floating charge for the purposes of s 395 of the *Companies Act.* This conclusion was on the basis that the essence of a floating charge is that unless or until the charge crystallises, the chargor should have unfettered freedom to carry on his business in the ordinary way in accordance with the second and third characteristics identified in the *Yorkshire Woolcombers* case. Accordingly,

as cl 53(6) provided that the employer had an absolute right to refuse to permit the plant's removal if it was immediately required to complete the works, and a qualified right to refuse if the plant was not immediately required, the element that the chargor should retain an unfettered freedom to carry on his business in the ordinary way was not met. This reasoning was rejected by the Court of Appeal. Millett LJ held:

The chargor's unfettered freedom to deal with the assets in the ordinary course of his business free from the charge is obviously inconsistent with the nature of a fixed charge; but is does not follow that his unfettered freedom to deal with the charged assets is essential to the existence of a floating charge ... The essence of a floating charge is that it is a charge, not on any particular asset, but on a fluctuating body of assets which remain under the management and control of the chargor, and which the chargor has a right to withdraw from the security despite the existence of the charge. The essence of a fixed charge is that the charge is on a particular asset or class of assets which the chargor cannot deal with free from the charge without the consent of the chargee. The question is not whether the chargor has complete freedom to carry on his business as he chooses, but whether the chargee is in control of the charged assets.

Millett LJ did agree with Jonathan Parker J in that by forbidding the contractor from removing from the site plant or materials required, whether immediately or not, for the completion of the works, the council was imposing a restriction on the way in which the contractor carried on its business. However, the Court of Appeal departed from Jonathan Parker J's reasoning as to the effect of this restriction in respect of the council's security. It

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> was held that the council's purpose in imposing the restriction was not to protect its security but to ensure that the contractor would give proper priority to the completion of the works. The Court of Appeal considered that a similar restriction would have been appropriate even if the council had not taken any security. Hence, it was not essential to the existence of a floating charge that the chargor should have unfettered freedom to deal with the charged assets and the restriction on the way the contractor carried on business was to ensure that the contractor would give proper priority to the completion of the works.

What were the consequences of the contractor's failure to register the equitable charge?

The Court of Appeal finally held that the failure to register the charge rendered the security created by the power of sale void as against the administrator, but it did not affect any other right of the council which was not a security and which did not require registration and, in particular, did not invalidate the council's contractual right to retain possession of the plant and materials in use to the complete the works. As mentioned above, since at the date that the writ was issued the works were not complete, the council's right to retain possession at the plant defeated the administrator's claim. However, the court concluded by adding that after the completion of the works, the council's right to continue in possession would be referable to a security which would be void against the administrator and could not prevail against him.

Conclusion

In this case, the Court of Appeal highlighted some important considerations in drafting 'vesting' clauses which practitioners should carefully follow. It indicated that such clauses should be clear and unambiguous and other provisions in the contract should be consistent if the intent is to transfer legal property in the plant and materials while on site to the principal. Further, the court considered the various rights given to the principal under the contract upon the abandonment of the works by the contractor and provided some interesting conclusions as to their nature. 🌣

Andrew Kelly, Allen Allen & Hemsley.

AIR NEW ZEALAND LTD & ENZEDAIR TOURS LTD V ISI JOSEPH LEIBLER, LEIBANT INVESTMENTS PTY LTD & NINTH ASTJET PTY LTD

Unreported, Supreme Court of Victoria, Hansen J, 19 November 1996

Issue

In these proceedings, the key issue was whether rectification of a contract could be sought either on the basis of common or unilateral mistake.

Facts

In 1984, Jetset Travel Holdings Pty Ltd (Jetset) was the largest tour and travel agency in Australia. Air New Zealand (ANZ) conducted an international airline and domestic services in New Zealand. Enzedair Tours Ltd (Enzedair) was a wholly owned subsidiary of ANZ. Jetset and ANZ had conducted business together since 1975.

The plaintiffs in this case were ANZ and Enzedair. The defendants were Isi Leibler, Leibant Pty Ltd (Leibant), and Ninth Astjet Pty Ltd (NAPL).

This case concerned a written agreement (the shareholders agreement) for the purchase by the plaintiffs of a one half share of Jetset from the defendants. Isi Leibler was the Managing Director of Jetset and was in effective control of Jetset as he or his family held 90 per cent o. the issued shares. It was important to note that NAPL held half of the issued shares in Jetset. All of the issued shares in NAPL were held by Leibant as trustee for a trust called the Joint Travel Investment Trust. The units in that trust were held as to 90 per cent by Iznaom as trustee for the Leibler Holdings Trust. Isi Leibler was one of the three directors of NAPL.

It was in respect of cl 10 of the shareholders agreement that the plaintiffs sought rectification. Clause 10 dealt with the sale or other disposition by a shareholder of its shares in Jetset. Clause 10 as it stood provided protection for the plaintiffe at the first level of ownership or control, that was, at the level of the shares in Jetset. However, there was no express provision providing protection at the second level, that is, there was nothing to protect the plaintiffs from the defendants' interests in disposing of shares in or downwards from NAPL. This was now an issue as Leibler and Leibant were threatening to dispose of the legal or beneficial ownership of their shareholding in NAPL to Qantas, a direct competitor of ANZ.

The plaintiffs' case was essentially that their solicitor had mistakenly and unnecessarily, without their knowledge, deleted the relevant clause from the draft shareholders agreement which had provided this protection at the second level (cl. 10.9).

Justice Hansen examined the

> extensive negotiations that resulted in the shareholders agreement in detail and, in particular, the deletion of cl 10.9. In summary, he found that:

- no person on the Jetset side ever asked that protection at the second level or cl 10.9 be deleted;
- the negotiations and agreements reached only required that cl 10.9 be amended. The amendments required did not involve the deletion of the plaintiffs' second level protection;
- the plaintiffs' solicitor was not instructed to delete cl 10.9 by the plaintiffs and the deletion of cl 10.9 was as a result of the solicitor's mistake as to his instructions:
- the plaintiffs did not notice that cl 10.9 and the right of preemption had been deleted, rather than amended as required; and
- the defendants were aware that cl 10.9 had been deleted but took no action to notify the plaintiffs of its omission.

Held

Justice Hansen granted declarations in the terms sought by the plaintiffs. He declared that the agreement be rectified by the reinsertion of cl 10.9 (giving the plaintiffs the second level protection) from the date of execution of the shareholders agreement.

Reasons

Justice Hansen examined the relevant law relating to both common and unilateral mistake. As Isi Leibler was aware of the mistake and intended to execute the agreement without ANZ having any second level protection, the plaintiffs' claim for common mistake failed. The analysis therefore focused on unilateral mistake.

The basic principle is that a party is entitled to rectification of a

contract upon proof that he believed a particular term to be included in the contract, where the other party has concluded the contract knowing that the first party believed the term to be included. As this principle has its foundation in equity, the issue is whether there are circumstances, in addition to the mistake of one party, which render unconscionable reliance on the document by the party who intended that it should have effect according to its terms.

The standard of proof required in an action for rectification is the civil standard, that is, on the balance of probabilities. However, cogent evidence is required to contradict the cogent evidence of the parties' intention displayed by the written document itself.

The defendants put forward

various submissions, including that: (a) a requirement of a claim in rectification is that actual knowledge of the other party's mistake be established, and that knowledge could not be satisfied on an objective basis. Whilst Justice Hansen thought that the true principle of rectification would allow the remedy to be granted even though the unmistaken party did not have actual knowledge of the mistake, this did not need to be determined on the facts of this case. Here, the defendants knew that the plaintiffs were mistaken as to the contents of the shareholders agreement at the

(b) as the defendants had merely remained silent, this was insufficient to found rectification. Justice Hansen also dismissed this submission. It is not essential that there be a misrepresentation. As a matter of principle, and subject always to the particular facts, where a party does nothing to correct a mistake in the document of which he is aware

time it was executed;

- and allows the other party to sign the document unaware, rectification will ordinarily lie;
- (c) there may well have been negotiations had cl 10.9 been retained and the final form of cl 10.9 might have differed. There was never any dispute regarding the second level protection and therefore Justice Hansen was not persuaded that doing the exercise of amending cl 10.9 affected the settling of other provisions. Further, Justice Hansen's view was that Isi Leibler clearly knew that a mistake had been made by ANZ and that he and NAPL remained mute, hoping for the benefit to his family's interest if the agreement as executed omitted any second level protection to ANZ. Therefore, Justice Hansen concluded that if this was not the case, the cause was the conduct of NAPL and Isi Leibler, in proceeding as they did and not intimating the mistake to ANZ. An estoppel cannot be grounded upon a person's own unconscionable conduct; and
- (d) rectification was not available here as the mistake by the plaintiffs' solicitor was to an erroneous view of the legal effect of the words. Justice Hansen also dismissed this submission. He did so on the basis that firstly, the solicitor's mistake was based on his failure to comprehend and implement his instructions and secondly, the primary mistake was the plaintiffs' belief that the agreement contained the second level protection. It was therefore not necessary for Justice Hansen to determine whether a mistake as to the legal effect of words appearing in a document could, in some circumstances, found a claim for rectification. &

Jodi Steele, Allen Allen & Hemsley.

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and stifles innovation. In an alliance contract, agreed performance indicators for cost reductions, customer service, safety, production rates and so on effectively act as warranties by both parties because their achievement determines both the contractor's remuneration and the owner's achievement of its goals.

In an alliance, there must be unrestricted sharing of information between the parties and total confidentiality vis a vis outsiders. The ownership of intellectual property developed during the alliance should be addressed by both parties.

Decisions are usually made by a committee with equal representation of the owner and the contractor. The ambit of this body's responsibilities needs to be carefully defined. Alliance or not, it is inevitable that disputes will arise. Alliance contracting is not a cure for all conflict and it should never be assumed that the parties will always be able to reach agreement. There has to be a binding solution available when this situation arises, usually through an independent third party such as an arbitrator or an expert.

Termination of an alliance contract should normally be possible only for insolvency or a serious breach. Any provisions which allow termination for convenience must be drafted so that the contractor has an opportunity to realise the fruits of its investment. •

Doug Jones, Partner, Construction, Engineering

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