WHEN CAN RECTIFICATION COSTS BE RECOVERED AS DAMAGES FOR BREACH OF CONTRACT? HIGH COURT CLARIFIES

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KEY POINTS

• Owners of buildings are entitled to rectification costs as opposed to merely the diminution in value of the building, subject to a test of necessity and reasonableness.

• There are still some unanswered practical questions.

INTRODUCTION

The question of what damages are recoverable by a principal under a building contract for defective building work has been reviewed by the High Court of Australia in its February 2009 decision of *Tabcorp Holdings Ltd v Bowen Investments Pty Ltd* [2009] HCA 8. While this was a matter arising under a commercial lease, the case which underpinned the High Court's judgment was a landmark building law case, *Bellgrove v Eldridge* (1954) 90 CLR 613. The judgment confirms that, as was established in *Bellgrove*, owners of buildings are entitled to rectification costs as opposed to merely the diminution in value of the building, subject to a test of necessity and reasonableness.

FACTS

On the morning of 14 July 1997, a representative of the landlord (Bowen Investments) of a commercial building just off St Kilda Road in Melbourne arrived for a meeting with the tenant (Tabcorp). The meeting was to discuss the tenant's proposals to alter the foyer of the building, which the landlord had yet to consent to. Even though the landlord had arrived early for the meeting, the tenant—and its demolition contractors—had arrived even earlier and commenced jack–hammering of the granite floor and removing cherry wood panelling from the foyer area.

The High Court dismissed all aspects of the tenant's appeal and affirmed an increase to the initial award by the trial judge from $34,820 to $1.38 million. The lower figure had been primarily calculated on the difference between the value of the property with the old foyer and the value of the property with the new foyer. The higher figure took into account the amount it would cost the landlord to restore the foyer to its original state.

HIGH COURT DECISION

In dismissing the tenant's appeal, the High Court went back to basics, confirming that the 'ruling principle' in relation to awarding damages for breach of contract is that a plaintiff, so far as money can do it, is to be placed in the same situation as it would have been in if the contract had been performed.

The Court noted that the words 'same situation' in this context do not necessarily mean 'as good a financial position'. This was crucial to the Court ultimately finding that the landlord was entitled, through the damages award, to have the foyer reinstated to its original state—complete with its high–quality and aesthetically distinctive materials—rather than simply recovering the difference between the value of the original and replacement foyers as a 'leasing tool'.

The facts in *Tabcorp* were likened to that of a building owner suing for defective building work. In *Bellgrove*, the High Court held that the cost of rectification is the default method of assessing damages, subject to two qualifications—the rectification work must be 'necessary to produce conformity' and a 'reasonable course to adopt'.

In *Tabcorp*, the High Court has now provided some further guidance as to the application of these two qualifications.

NECESSARY TO PRODUCE CONFORMITY

The tenant relied on evidence that the foyer would need to be substantially refurbished at the end of its occupancy, and that the landlord would suffer no loss as the rectification work would not be 'necessary'.

The Court dismissed this argument, saying that it represented a misunderstanding of what 'necessary' means in this context. The Court reiterated that this limb of *Bellgrove's* test requires that the rectification work be 'necessary to produce conformity' in the sense that the work is 'apt to conform with the plans and specifications which had not been conformed with'. Applied to this case, that meant 'apt to bring about conformity between the foyer as it would become after the damages had been spent in refurbishing it and the foyer as it was at the start of the lease.'

In other words, the Court is emphasising that the principal is entitled to get what it bargained for. The contract between the parties required that the foyer not

be altered without consent, so the landlord was entitled to the cost of the work which was necessary to bring it back to what it had been before the unauthorised demolition.

REASONABLE COURSE TO ADOPT

The High Court also considered the reasonableness qualification of the *Bellgrove* test, framing it as a question of whether rectification would be 'unreasonable'.

The Court noted that this test of 'unreasonableness' will only be satisfied to disallow recovery of rectification costs in fairly exceptional circumstances. Using the example in *Bellgrove*, if a building contract for the erection of a house with cement rendered external walls specified that second hand bricks would be used and the builder used new bricks, it would be unreasonable for the owner to claim the cost of demolishing the building and rebuilding it with second–hand bricks.

The Court also noted that the requirement of reasonableness does not mean that any excess over the amount recoverable on a diminution in value basis is unreasonable.

Is the commercial nature of the building relevant?

The tenant also argued that the commercial nature of the building should be taken into account in determining the appropriate method of assessing damages. At trial, the judge accepted evidence that the old foyer was no more effective as a leasing tool than the new foyer. The tenant argued, therefore, that the only loss suffered by the landlord in this commercial venture was the diminution in value of the building.

The High Court dismissed this argument, again emphasising that a contracting party is entitled to get what it contracted for. In this case, the landlord wanted the original foyer and it was no answer to the landlord's case to say that reinstating the original foyer was not in the landlord's commercial interest.

UNANSWERED QUESTIONS

While the High Court has confirmed the continued currency of the principle in *Bellgrove*, it has also left unanswered at least three practical questions regarding the application of that principle:

• Whether the intention of the owner to rectify (or the absence of it) is a relevant consideration when applying the *Bellgrove* principle. In the Full Federal Court's decision in the *Tabcorp* matter it was held that the landlord's intention to restore the foyer was, in fact, relevant as reasonableness is not solely determined from the viewpoint of a 'rational economic actor'. However, the High Court did not make any additional observations specifically about intention in *Tabcorp*. This may be because the landlord's intention to rectify had been asserted from the outset and was never really in issue. Nonetheless, given that recent cases like *UI International Pty Ltd v Interworks Architects Pty Ltd* and *Westpoint Management Ltd v Chocolate Factory Apartments Ltd* have made it clear that the owner's intention to rectify may be a relevant consideration, this remains a developing area of the law.

• Whether rectification would be unreasonable, if the cost of rectification is wholly disproportionate to the benefits of rectification. Issues of proportionality have been especially important in England since the decision in *Ruxley Electronics and Constructions Ltd v Forsyth*. In that case it was held to be unreasonable for an owner of a swimming pool to insist that the pool be dug up and rebuilt because its maximum depth was only 6 feet rather than the specified 7 feet 6 inches. While the High Court distinguished the facts of *Ruxley* from those in *Tabcorp* and made it clear that the fact that the cost of rectification exceeds the diminution in value does not, of itself, make the rectification 'unreasonable', the Court did not engage directly with the applicability of the proportionality doctrine.

• Whether certain supervening circumstances could result in rectification costs becoming an 'unreasonable' measure of damages. We looked at this particular question in 2006 following the decision in *Scott Carver v SAS Trustee Corporation* [2005] NSWCA 462. In that case, it was noted that awarding rectification costs may be unreasonable if there are supervening circumstances to show with substantial certainty that rectification will not happen.

Tabcorp does not purport to provide a comprehensive treatment of all possible issues relating to defective work damages. Nonetheless, it does provide very strong guidance, by way of a joint judgment from five Justices of the High Court, as to the continued currency of the test in *Bellgrove*, along with clarification of the way in which its two–limbed qualification operates..

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