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Employer's right to compensation when neither the contractor nor the employer has remedied a fault in construction work

Construction disputes, aside of disputes in which a consumer is the employer, have long been determined almost exclusively by arbitration, which has led to the absence of precedent. In recent years, however, a number of cases have been heard by the general courts and by granting leave to appeal in a number of disputes, the Supreme Court has demonstrated an interest in addressing construction law issues to establish case law concerning the interpretation of the standard industry agreements that are used by the market, primarily those referred to as AB and ABT.

On 23 December 2014, the Supreme Court handed down its judgment in a well-publicised construction case. The matter primarily concerned the much-discussed question of whether an employer in a turnkey construction project governed by ABT 94 is entitled to compensation for remedial costs where neither the contractor nor the employer has yet remedied the fault.

Background to the case

The case concerned a contract for a turnkey project in which faults were discovered in the newly erected building after approval in a final inspection. The faults were held to be of such nature that they substantially affected the satisfactory condition or appearance of the construction or the ability to use it for its purpose. The contractor was therefore held liable to remedy the faults but had failed to do so. Nor had the employer remedied the faults under its right to do so. According to the employer, it would cost several million Swedish crowns more than the contract price to remedy the faults in the building.

The questions which the Supreme Court faced were, in part, whether the employer in a turnkey construction project is entitled to estimated remedial costs for material faults that have not been remedied by either the contractor or the employer and, in part, whether the employer could claim compensation for the depreciation in the building's value.

Judgment of the Supreme Court

The provisions in ABT 94 (which has now been replaced by ABT 06) that were applicable in the case are contained in chapter 7, section 25 in respect of remediation and in chapter 7, section 26 regarding the right to reduce the contract price in the event of non-material faults. With minor amendments, these sections correspond to sections 17 and 19 in chapter 5 of ABT 06.

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The rules in ABT 94 are founded upon the approach that construction faults are to be effectively remedied either by the contractor or by the employer at the contractor's expense or, when the fault is not material and the costs are not in proportion to the significance of the fault, a reduction of the contract price. However, the Supreme Court states that, *"The situation in this case gives rise to the question as to what applies if the employer cannot, or will not, remedy a confirmed material fault. One question is whether he is entitled to compensation for estimated remedial costs, another is whether he is entitled to a reduction in the contract price."*

Right to compensation for the cost of remedial work

Because the Supreme Court found that the wording in the contractual provisions relating to remediation were unclear, it was necessary to construe them. When entering into the contract, the parties had not discussed these provisions and thus had no common understanding as to how the disputed provisions were to be construed. Because the parties had no common intention, construction of the contract on the basis of general contractual principles is to be made on objective grounds. The starting point is then in the first place the wording of the provisions. When this is insufficient, guidance may instead be sought in the systematic approach of the contract and the contents of other terms. If the systematic approach of the contract also fails to provide guidance, then the contractual terms shall be construed in the light of applicable non-mandatory law. Ultimately, an assessment of the reasonableness of the contract is to be made.

Under Swedish law, only where the employer is a consumer is there some legislation which is applicable to construction contracts. There is a complete lack of legislation that is directly applicable to construction contracts where the employer is not a consumer.

In the absence of legislation, the courts usually use the provisions of the Sale of Goods Act as guidance for contracts that are not directly governed by the Sale of Goods Act. Under the Sale of Goods Act, the buyer has, in a corresponding case, the right to remedy faults at the seller's expense, which is to be seen as damages. Furthermore, the Supreme Court in previous rulings has arrived at the conclusion that damages shall also be payable when no remediation has taken place. The Supreme Court concludes, however, that it is to be borne in mind that it is a matter of two different types of contract (sales agreements and construction agreements) and that in the construction of certain terms there is reason to take into consideration the special characteristics of a construction agreement. Chapter 7, section 25 of ABT 94 merely governs, as mentioned, the right for the employer, at the expense of the contractor, to remedy the fault but not what happens if the employer will not, or cannot remedy the fault. On the basis of this rationale, the Supreme Court draws the conclusion that the provisions do not entail that remediation is an exclusive remedy, i.e. that all other types of remedy that are not directly stated in the provisions are excluded.

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Furthermore, the Supreme Court concludes that the rules regarding the liability of the contractor vis-à-vis the employer shall not be construed so that self-help by the employer is the only way to obtain compensation for the employer when the contractor breaches its duty to remedy faults. The liability to pay compensation in the event of a breach of the remedial duty appears additionally, according to the Supreme Court, as reasonable and in accordance otherwise with the rules because the contractor made a conscious choice not to remedy the fault of which the employer had notified it and cannot then in any case invoke the limitation of liability that would otherwise follow from the liability rules under ABT.

Thus the Supreme Court holds that the employer is entitled to damages due to the contractor's failure to remedy the fault. There is a presumption that remediation will take place. The employer then has a right to compensation corresponding to an estimated cost of remedial work. If it is clear that the employer does not intend to remedy the fault, compensation in accordance with the principles governing damages will instead be determined as being the pecuniary effects of the fault at hand.

The right to a reduction in the contract price

In respect of the matter of the right to a reduction in the contract price, the Supreme Court concludes that that chapter 7, section 26 of ABT merely provides for a price reduction for faults that *"do not substantially affect the satisfactory condition or the appearance of the construction or the ability to use it for its purpose"*. The thought underlying this provision is that all faults are to be remedied by the contractor but that there is reason to make exceptions to the contractor's liability to remedy a fault when remediation would not be proportional to the benefit. Compensation can then be provided in the form of a reduction in the contract price. The question that then arises is whether the provision can be construed contrarily so that it precludes material faults from giving rise to an entitlement to a reduction for depreciation in value. The Supreme Court concludes that the difference between the remedies for material and non-material faults is a significant part of the systematic approach to liability in ABT and states that, *"the systematic approach of the chapter and the circumstance that the provision makes an exception from the main rule on remediation supports an understanding of the rules as a derogation from dispositive law."* This leads to the conclusion that ABT 94 cannot be given the interpretation that there exists a possibility of a reduction for depreciation in value for material faults.

Conclusion

The Supreme Court in its judgment holds that there is a right to damages for an employer corresponding to the estimated cost of remedial work. The Supreme Court deemed on the other hand that a right to a reduction of the contract price for depreciation of value in the event of material faults would go beyond the wording of the provisions, which is why the contractor shall not be liable to pay to the employer any compensation for depreciation in value when the fault at hand is material.

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As opposed to non-mandatory law in the Sale of Goods Act, in which it is possible to combine remedies and which are thus not exclusive, there is, in respect of construction contracts regulated by AB or ABT, only one remedy if it is not possible to rectify the fault, namely compensation for estimated remedial costs. Under the rules governing the sale of goods, there is always a right for the buyer to claim a reduction in the price if no remediation takes place. Remediation, damages and a reduction in price can thus be actualised for a single fault. Within construction law where AB or ABT apply, the actual remedies (for material faults) remediation of the fault and damages are, however, exclusive and cannot be used together.

Final comments

The result of this case opens up a possibility for an employer to defer remedying a material fault that the contractor has refused to rectify and instead first to claim compensation from the contractor. It shall be noted, however, that the right to compensation corresponding to the estimated cost of remedial work presupposes that the contractor cannot prove that there is reason to question the presumption that the employer really has the intention to remedy the fault. In order to avoid this risk, it may also continue to be worthwhile for the employer to remedy the fault anyway before the court rules on the case. If the parties are not in agreement on the cost of remedial work, it may also help to be able to refer to invoices regarding actual work carried out rather than quotes concerning planned work.

Considering the uncertainty which existed before the Supreme Court ruled on this case, the increased clarity provided by the ruling can nonetheless be seen as satisfactory – at least from the employer's perspective.

The question is what will be the impact of this judgment. One interesting fact is that three of the five judges sitting on the case dissented (albeit in different questions), which may indicate that the matter has not yet finally been resolved. In the next revision of the AB contracts, it is most likely that this question will be on the agenda and then both sides will be able to obtain arguments in the ruling of the Supreme Court.



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