



The Supreme Court's Precedential Ruling on Infrastructure Projects - Have the Rules of Contract Interpretation Been Redefined?

Dear Clients,

The Supreme Court recently adopted a precedent-setting approach to contract interpretation, in a claim by a construction company against Israel Railways. The dispute focused on monetary claims by the construction company for additional payments, beyond the amount specified in its contract to perform infrastructure work for Israel Railways. The construction company's claim was based on additional costs that it incurred in performing the work, due to causes such as an increase in the cost of iron and the laying of extra layers of gravel.

In considering the claim, **the Supreme Court expanded its review to include the fundamental questions at the basis of contract interpretation in general, and specifically the rights of parties under a construction agreement.**

The Supreme Court considered whether the wording of the contract is the principal tool of interpretation, or whether the court has the freedom to look into the presumed intent of the parties, even if it is not reflected in the wording of the contract itself. Justice Stein began by distinguishing between different types of contracts based on their characteristics ("not all contracts were born equal"). According to Justice Stein, there are '**open contracts**' which are worded in more general terms, usually used to serve long-term business relationships ("**relationship contracts**"), and '**closed contracts**', where the terms are defined clearly and in a detailed manner. Justice Stein ruled that the court will be more inclined to read new obligations, which are not explicitly specified, into open contracts based on general legal principles, such as good faith, fairness and reasonableness. However, the court will be less likely to use general legal principles in order to reframe the parties' obligations under contracts classified as closed contracts.

The Supreme Court classified the construction agreement attached to the Israel Railways tender documents as a closed contract. Therefore, the court applied a formalistic approach that follows the contract to the letter, including pricing and pricing change methods set by the contract, because the contract's express terms reflect the allocation of risks between the parties. The Supreme Court rejected the District Court's ruling, which gave precedence to fairness considerations external to the contract, and the Supreme Court ruled that Israel Railways is entitled to the benefit of the contractual and commercial security awarded to it by the contract.

The other Justices in the case supported this conclusion, although they reached it by different means. Justice Fogelman emphasized that the Israel Railways contract was the result of a tender process, and the principle of equality in tenders drastically limits the ability to deviate from the contract's wording. Justice Grosskopf based his ruling on a different classification of contracts - a 'business contract' signed between two sophisticated commercial entities, as opposed to a 'private contract' signed between two parties inexperienced in drafting contracts. With regard to the business contract category - the classification which applies to the contract in question - Justice Grosskopf ruled that priority must be

granted to the wording of the contract, in order to ensure contractual certainty and honor the parties' decisions.

The Supreme Court applied these guiding principles to the issues in dispute between the parties. Below are a few examples.

- **Delay in performance due to factors not under the contractor's control** - The construction contract provided for NIS 20,000 of compensation to the construction company, if it was forced to delay performance due to no fault of its own, regardless of the duration of such delay. The construction company claimed that such a delay caused it damages exceeding NIS 9 million. The District Court awarded the construction company compensation of NIS 4,600,000, based on a formula that is generally included in governmental contracts for dealing with delays, even though it was not included in the construction contract with Israel Railways. The Supreme Court reversed this ruling and awarded the construction company compensation of only NIS 20,000, as stipulated pursuant to the construction agreement's provisions.
- **Increase in the price of iron** - The District Court awarded the construction company compensation of NIS 1,500,000 for an unexpected rise in iron prices (presumably due to accelerated construction in China in light of the Beijing Olympics). The Supreme Court rejected this ruling and stated that the parties should not deviate from the price adjustment mechanism stipulated in the construction agreement, which was tied to the consumer price index.
- **Work changes** - In the course of the project, Israel Railways ordered the construction company to perform 13 change orders. The construction company did not follow the procedure specified by the construction agreement for objecting in real time to the pricing of these works, and only at a later stage did it file monetary claims on account of these works. The court rejected these claims on procedural basis. In addition, the construction company claimed that some of the change orders effectively constituted a new contract that is not subject to the provisions of the construction contract between the parties. The Supreme Court rejected this claim, stating that the construction contract applies to these works as well, and adding that if these works were indeed a separate agreement, they could not have been awarded to the company without a tender process.

The above are just a few of the many claims by the construction company on which the Supreme Court ruled. Construction companies, clients and their legal advisors will find much material of interest in the Supreme Court's examination and analysis of each of these claims. This precedential ruling emphasizes the importance of careful examination of risk allocation between a client and a construction company, and a clear and explicit manifestation of such risk allocation in the contract.

The impact of the Supreme Court's ruling extends well beyond the interpretation of infrastructure contracts, and without question this ruling is an important step in defining the interpretation rules which apply to Israeli contract law.

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