

Managing commercial risk in construction contracts

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Background

As is the case for many sectors, 2020 has been a turbulent one for the construction industry in the region. COVID-19 and the economic fallout, the extent of which is yet to become clear, continues to disrupt the industry in the short term but the impact on 2020 is likely to be felt in the medium and long term.

This article briefly considers some of the short term steps which contractors and sub-contractors can take to manage and mitigate the risks posed by the current situation and considers what the longer-term repercussions, positive and negative, of COVID-19 may be.

The short term

In the short term, the key consideration for many in the supply chain will be protecting cash-flow. This is not a new concern in the industry and has been the subject of many articles prior to 2020. Nonetheless, COVID-19 has undoubtedly exacerbated this problem as a result of:

- existing projects being suspended or terminated;
- employers delaying/failing to certify payment applications and to make payments;
- a slow-down in the pipeline of new projects;
- delays to existing projects;
- increased operating costs; and
- developers calling, in some cases (for example recent articles in the UAE press) publically, for contractors to accept price-cuts on existing contracts which already contain tight margins and tough risk profiles.

In order to manage this increased risk, more important than ever is to ensure that contracts are pro-actively managed at every level of the supply chain.

Pro-active management of contracts draws out potential issues which may give rise to payment disputes at an early stage. Most construction contracts used in the region, notably the 1987 and 1999 FIDIC suites, contain provisions for the early notification of any instruction or event giving rise to additional cost. All too often these provisions are either ignored or are paid only lip-service which can lead to disagreement as to entitlement to payment and/or the amount due arising long after works have been undertaken.

As part of proactive management of contracts, two further 'common sense' steps are vital to being able to support a claim in respect of payment:

- Firstly, it is important that those managing the contract and making decisions in respect of it are familiar with and understand the contract. It is still all too common to discover that contracts which contain particular payment and notification provisions have operated on the basis of custom and practice or on the assumption that the standard FIDIC 1987 provisions will apply. Where this occurs, procedures are inevitably not followed leading to the loss of rights to claim (for example due to late notification) and/or statements are made or not made which ultimately prejudice the contractor's position.

- Secondly, proper records of costs incurred and of any instructions or occurrences which may give rise to later claims are vital. Whilst most projects do keep records, it is important that these records are complete, objective, contemporaneous and most importantly record the information which is: (a) required by the contract; (b) would be required to properly evidence a claim for costs. Further, where contracts permit it, video and pictures of progress on a weekly or monthly basis are invaluable to evidence entitlement to payment and refuting questionable Engineer's assessments.

Whilst managing the contract may help in bringing issues to light and ensuring compliance with the contract so as to avoid losing the right to claim, this is only part of the story as effective contract management it does not necessarily help in securing payment. Where employers are not prepared to make payments then contractors need to be aware of the potential remedies in their contracts and, at law, seek to use those remedies to secure payments, at least of sufficient amounts to manage cash-flow pending future disputes final resolution.

This is, of course, a difficult balancing act that can be challenging for contractors seeking to balance the need for payment against maintaining commercial relationships with an eye to future opportunities. That said, it is becoming increasingly common, notably amongst larger contractors and consultants, to decide not to seek future opportunities from employers with a history of failing to honour payment commitments.

A contractor's chief remedy for non-payment, short of termination, is to slow-down performance or suspend the works (or, at least, to threaten to do so in part or in full). Some contracts contain provisions allowing for such slow-down or suspension in the event of non-payment (for example Clause 69.4 of the 1987 FIDIC Red Book Contract). Such contractual rights are beneficial to contractors as there is a clear and unambiguous right to slow-down or suspend in prescribed circumstances (specifically in the event of failures to certify and failures to make a payment). When such rights are invoked, contractors must ensure they have satisfied the preconditions to slow-down performance or suspension (for example notice requirements) and should ensure they have sufficient evidence of the employer's breach to ensure they are protected from future claims that the slow-down or suspension was not justified. Indeed, the wrongful slow-down or suspension could expose the contractor to significant repressions so it is typical that contractor only take such assertive action in respect of uncontested breaches by the employer (or breaches that the employer is objectively unable to justify).

Where the contract is silent as to suspension, in most jurisdictions in the region the applicable civil code will contain a statutory right to suspend. In the UAE, Article 247 of the UAE Civil Code provides for suspension in certain circumstances:

When exercising a statutory right, care must be taken to ensure that there are performable mutual obligations and that the breach is proportionate to the decision to suspend. Once again, this comes down to the prevailing circumstances, being able to evidence that the contractual pre-conditions to the obligation to make payment have been met (for example submission of supporting documents) and that there is clear evidence of the amount due.

The Medium term

Looking ahead to new contracts, it seems that there is likely to be even more competition for a limited pool of contracts as a result of the economic impact of COVID-19 (although the infrastructure and industrial sectors may well be exceptions) as well as the pre-existing trends in the regional market prior to 2020.

In those circumstances, the risk is that a "lowest-price wins" approach to procurement will dominate and that contractors will be asked to accept ever more risk for ever lower margins. As discussed below, it is hoped that 2020 may provide a 'reset' for the industry and lead to a move towards a more balanced risk

profile, however, only time will tell if this is likely to happen. In the meantime, it is more important than ever that contractors have a clear understanding of their risk profile and ability to deliver against the same from the early stages of procurement through to delivery of the works.

In negotiating a construction contract, it is common for employers to seek to transfer as much risk as possible to the contractor despite the fact that a contractor may be less well placed to manage that risk. In this regard, we have seen a tendency for pure construction- only contractors being asked to accept full design responsibility. In a commercial environment where procurement decisions are often based on landing the lowest price, contractors are forced to submit a competitive bid, which can result in low profit margins. It follows that that contractor is then even less able to absorb the risk. This is increasingly prevalent in the current market, with contractors being asked by clients to re-price contracts to accommodate the economic fallout from the COVID-19 pandemic. The consequences of such pricing are then inevitably passed down the supply chain (although we are aware of various instances when the underlying forms of subcontracts have made no provision for this).

However, and notwithstanding the increasingly competitive nature of the contracting market, contractors should nevertheless ensure that the contract clearly addresses fundamental issues in respect of extension of time entitlements and additional costs (including in respect of the evolving impact of COVID-19), variations, limitations on liability and dispute resolution.

Contractors should ensure that the contract makes provision for the following:

1. Extension of time and additional costs

Contractors should ensure that there are clear provisions in the contract that allow for an extension of time where there are delays to the project that are unforeseeable, outside of their control, and/or are not caused by the contractor. In addition to provisions for an extension of time for such delays, the contract should provide for additional costs to be claimed, and potentially a variation to the contract price. The interplay between these provisions and the force majeure provisions often overlooked in negotiation, should be carefully considered to ensure there is some right to additional cost in the event of force majeure events and/ or a right to take action to mitigate or avoid additional cost being incurred as a result of 'no-fault' events.

2. Variations

In the increasingly fast changing market (not just for construction but for the real estate market and the sectors in which the buildings will ultimately be used) effective variation mechanisms are crucial. Contractors should ensure that they are able to notify variations or changes of circumstances which incur additional cost and/or time. This may include revisiting force majeure provisions, employer's risks and often overlooked provisions such as changes in law and fluctuation provisions (in relation to cost of materials and labour) as well as considering who carries the risk for delay and disruption in the materials supply chain. A further area where contractors can seek to regain the ability to mitigate risk is in amending variations provisions to require the cost consequences of instructions to be agreed upon before work has to be undertaken (save in an emergency). Whilst this may be difficult to negotiate this is an area in which contractors can seek to improve their bargaining position by securing relatively limited changes to the contract.

3. Penalty Clauses

Contractors should pay attention to the way penalty clauses, for example, delay damages, work with clauses dealing with variations and force majeure events. Where there is a justifiable delay the contractor should not be penalised even if the event is not itself the employers ' fault'.

4. Dispute Resolution Provisions

With regard to dispute resolution, It has long been considered the 'safe' option to include arbitration agreements in construction contracts. Whilst arbitration undoubtedly has some advantages over the local courts in certain circumstances, a major drawback is a cost involved in arbitral proceedings. For lower value disputes arbitration, even adopting an expedited procedure (for example as provided by the ICC Rules), is unlikely to be cost effective. As a result, many 'small' disputes are never resolved and the aggregate loss suffered by a contractor over multiple small disputes could be significant. The above

issue tends to penalise contractors and sub-contractors rather than employers. In order to mitigate this, it may be possible to negotiate a tiered dispute resolution provision allowing large disputes to be referred to arbitration but providing that below a certain threshold 'small' disputes can be referred to the local Courts, while it is also noteworthy that certain courts (such as the DIFC Court) have small claims divisions. This is by no means a perfect solution, however, it gives contractors a forum which is more likely to be cost effective in which to resolve small disputes. Perhaps more importantly, it keeps alive the risk of litigation which may bring employers to the negotiating table – without this, employers can be confident arbitration will not be cost effective and so there is little incentive to resolve matters amicably.

The Long Term

Prior to the unexpected events of 2020, there was discussion in the UAE and the wider region about the future of the market and the need for a more sustainable model to be adopted. Steps have already been taken, for example, the Abu Dhabi government's decision to impose 30 day payments terms on its contracts, to move towards a more balanced risk profile, but more remains to be done. The 2019 report issued by Mashreq Bank focused on the potential for change in the UAE construction market to create a more sustainable model. It focused on: (a) the introduction of a more balanced risk profile perhaps through the introduction of a standard form of contract or via legislation imposing minimum standards on the industry (b) reviewing dispute resolution procedures, and to ensure that disputes can be resolved more quickly to aid cash-flow (for example through the use of a specialist court or adjudication scheme similar to those used in jurisdictions such as the UK and Australia). Despite the dramatic shift in the current state of the industry and the economic outlook in the immediate future, the issues identified in that report remain front and centre. It is possible that the aftermath of COVID will create greater urgency to move towards a sustainable model for the industry. No matter what level in the supply chain you operate at, it is in no-one's interest for otherwise viable contractors to be driven out of the market due to cash-flow issues reducing the pool of competitive contractors or for ongoing projects to be threatened by the delays and complications of a contractor or sub-contractor insolvency. If it is the case that public sector contracts and infrastructure works become a bigger proportion of the pipeline of future work in the next few years, COVID may well provide an opportunity for the public sector to expedite change. Through the adoption of new risk-profiles designed to allocate risk to the party best able to manage that risk and through championing prompt payment the public sector can begin to bring about positive changes to the industry which will set it on a more sustainable course for the future.

Of course, the above is speculative and only time will tell how COVID reshapes the construction sector (and indeed the wider economy). What is certain is that in these difficult times it is more important than ever for contractors to ensure they manage contracts and so risk effectively but, at the same time, to actively embrace new opportunities that arise.

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