CONSTRUCTION CONTRACT REFORM: Ten Guidelines the Government Could Adopt

By Sarah Holderness & Nick Gillies

"We need to lead by example and if there are things that we can do to take a leadership position with that industry then we should be." Prime Minister Ardern[1]

As 2018 drew to a close, another high profile contractor failed with Corbel Construction going into liquidation, followed by Arrow International entering voluntary administration early in the New Year. This is on the back of Ebert Constructions' receivership in July 2018,[2] Fletcher Building's near $1b losses, the financial difficulties of Hawkins, and further back the collapse of Mainzeal in 2013 – to say nothing of the insolvencies of smaller subcontractors and suppliers which do not make the headlines. It is widely accepted that this trend reflects structural problems in the construction sector, especially when these failures are occurring at a time of unprecedented demand. Change is needed if New Zealand is to have a competitive and financially stable industry that can meet the $41b of forecast spending over the next five years, and beyond.[3] There are multiple causes for this trend, including industry fragmentation, a lack of scale, short term decision-making, price-driven procurement, inappropriate risk allocation, and unbalanced contractual terms.[4] Apropos Derek Firth and John Walton – two senior construction barristers – recently wrote about the need for reform, and in particular the unfortunate tendency to procure works on the lowest cost basis, often before the detailed design is properly developed, and with the contractor assuming undue risk.[5] There is also preoccupation with engaging a single contractor (rather than contracting directly with the larger sub-trades), even where the contractor is undertaking little, if any, physical works themselves and are essentially a glorified project manager. This can have insurance implications and, as we have seen, leave subcontractors out of pocket if the contractor falls over.

This article focuses however on the importance of balanced agreements that fairly allocate risk and reflect the parties' legitimate commercial interests. Entering into a contract with one-sided terms does not serve either party, including those in whose favour the terms may be set. A lopsided contract invariably leads to an adversarial relationship, greater contractual bureaucracy, more claims and an increased risk of disputes. None of this is conducive to quality construction, cost control or efficient collaborative working when the unexpected inevitably arises.

As the largest purchaser of construction work in New Zealand, it is essential that central and local government lead by example, not only when tendering public sector projects, but also when presenting and negotiating terms.

In August, following the collapse of Ebert, the Government held emergency talks with industry leaders to better understand the problem and what might be done to ensure a healthy and competitive industry. Other than upskilling workers and encouraging departments to adhere to government procurement guidelines that specify a whole of life approach, so far there has been little in the way of tangible change. BRANZ is currently researching how procurement strategies and practices support building quality in New Zealand, although it is unclear whether this will extend to contracting models and terms.

In Australia the NSW Government has introduced a *"10 Point Commitment to the Construction Sector"* in response to similar problems.[6] The New Zealand Government is understood to be monitoring this and considering whether something similar might be adopted here. However, there are some steps

response to similar problems.[6] The New Zealand Government is understood to be monitoring this and considering whether something similar might be adopted here. However, there are some steps that could be taken now without needing to wait, which would be in line with its acknowledged *"leadership position"* in the sector.

So, as a starter, here are ten specific guidelines or changes the Government could adopt in its approach to construction contracts, which would make a meaningful difference:

1. **Liability *limits***: Contractual limits on liability are a sensible and straightforward way of managing risk. They are commonplace in other types of commercial contracts and in consulting agreements, but are not always present in construction contracts.

When preparing construction contracts it should be standard practice for central and local government to include an overall monetary cap on both general liability and liquidated damages and to exclude indirect or consequential losses. A contractor or consultant should not be expected to assume unlimited risk.

2. Hard time bars: It is common for construction contracts to contain strict time bars for notifying variations, extensions of time, claims, and the like. The time periods are often short and coupled with a requirement to include various (sometimes excessive) information. The consequences of failing to give proper notice within the stipulated time can be severe if these requirements are a condition precedent: the contractor may lose all rights to the particular claim simply because of a procedural defect.

The usual rationale for hard deadlines is 'project discipline', but this is hardly justification when the consequences of non-compliance are far reaching. Discipline can still be maintained without a condition precedent by allowing late claims to be valued as if they have been notified on time but not invalidating them altogether.

3. Ground risk: Perhaps the most fraught area for allocating risk in construction is what lies beneath. Usually critical to the build process, site conditions can change quickly over short distances, and ground investigations are by no means a guarantee of what may be found during excavation. The consequences in terms of construction

process, site conditions can change quickly over short distances, and ground investigations are by no means a guarantee of what may be found during excavation. The consequences in terms of construction method, programming and cost can be enormous. As a result, the practice of presenting terms that allocate most (if not all) site risk to the contractor is unfair and misplaced, unless a premium is to be paid to avoid that risk. There should be mutual risk sharing according to what is appropriate for each project, and draft terms presented by government ought to start from that footing.

4. Fitness for purpose: There is no place for fitness for purpose obligations in construction contracts. To begin with, this obligation cannot be insured against. What is more, consultants and contractors have a duty to design and construct according to the specification and with reasonable care; it is not reasonable to expect them to go further and effectively warrant that the design or structure will also be fit for purpose.

5. Defect Liability Periods: A DLP obligation is standard fare in construction contracts. It requires the contractor to remedy defects or snags that emerge within a specified period following practical completion. However, this should not be structured as an 'evergreen' DLP – whereby the DLP across the whole works is re-set each time a defect is identified or remedied however small it might be. That approach establishes an uncertain and potentially indefinite liability period, with disproportionate consequences for the contractor in terms of retentions, banking requirements, and balance sheet. It also raises the question of whether retentions are necessary at all on public sector projects given the cashflow impact, the Government's buying power, and the other sanctions/ remedies available to protect against a recalcitrant contractor.

6. Time at large: Modern construction contracts include provisions that allow extensions of time if the contractor is delayed through no fault of their own. Nonetheless, while rare, these provisions will not necessarily respond to every conceivable delay event that is outside the contractor's responsibility. This is where the 'prevention principle' will step in to provide a safety valve by putting time "at large". Trying to prohibit by contract time being put at large misunderstands the prevention principle and will potentially cause significant injustice, especially if liquidated damages are specified.

7. Concurrent delay: Where construction works are delayed at the same time by two independent causes – one the fault of the contractor and the other the responsibility of the principal – the contractor would usually receive an extension of time but not prolongation costs. That way the contractor avoids delay damages but must bear the additional cost of having extended overheads. This risk sharing should not be altered so as to deny the contractor an extension of time. For more on concurrent delay please see: A Guide to Concurrent Delay.

8. Standard forms: The construction sector benefits from various standard form agreements, which are widely recognised and understood, and are reasonably well balanced. As a result, they require significantly less negotiation and revision than bespoke agreements. Most head contracts are based on standard form conditions, which ought to be universal for public sector projects. For consistency, contractors could also be asked to subcontract on standard forms (eg SA-2017).

While some amendments are usually necessary to tailor standard forms to the particular project, the volume of special conditions in government contracts can be excessive in an attempt to re-set the balance too far in favour of the principal.

9. Engineer to the Contract: The Engineer has an important role in the efficient and just administration of a construction contract. Problems arise where the Engineer is unable (or is perceived as being unable) to discharge their decision making functions fairly and impartially. To mitigate this familiar issue, at least for larger public projects, the Engineer should be appointed outside of the design team to maximise their independence. For more on this please see: We need to talk about the Engineer.[7]

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10. Dispute Resolution Boards: DRBs are an effective means of resolving issues during a project. In the nature of a 'spot' arbitration, a board (of 1 or 3 independent persons) is empowered by contract to assist the parties and make determinations during the life of the project. What distinguishes it from other dispute resolution processes is that the board is already familiar with the project and considers issues contemporaneous with the works. As a result, there is an emphasis on avoidance as much as resolution, and the upfront cost usually results in a long term saving. DRBs ought to be the default choice for complex/larger (say $20m+) public projects, and with the board having regular engagement with the parties and not simply be a standing board. For a detailed discussion of DRBs please see: A case for Dispute Resolution Boards.[8]

Disclaimer: The information contained here is of a general nature and should be used as a guide only. It is not a substitute for obtaining legal advice. Any reference to law and legislation is to New Zealand law and legislation.

End Notes

[1] Post Cabinet Press Conference, 6 August 2018.
[2] See Hesketh Henry's Ebert Updates: What You Need to Know (23 August 2018); Receivership and Liquidation (18 October 2018); and Court Guidance on Retentions Trust Regime (19 November 2018).
[3] 2018 National Construction Pipeline Report.
[4] For further reading on the industry, see: N Gillies The Construction Landscape in New Zealand (21 December 2015).
[5] D Firth How to rebuild the construction industry NZ Herald (30 September 2018), and J Walton Crisis? What Crisis? Time for structural reform in the construction industry Law Talk Issue 923 November 2018 at 23.
[6] www.infrastructure.nsw.gov.au/media/1649/10-point-commitment-to-the-construction-industry-final-002.pdf
[7] Building and Construction Law Journal (2018) 34 BCL 179.
[8] Arbitrators & Mediators Journal (December 2014), Vol 33, No 2.

ABOUT THE AUTHORS

NIck Gillies
Partner

Sarah Holderness
Senior Associate

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