Construction

June 2014

CONSTRUCTION BULLETIN

Welcome to the June edition of our Construction Bulletin

Last month saw the publication by Informa Law of a new specialist book, written by the Partners of HFW's construction team, called *Construction Contract Variations*. This edition of our quarterly Construction Bulletin is devoted exclusively to this subject. In particular, we cover the following topics:

- **Change at the centre of disputes:** disagreements about instructed changes not only lead to disputes about the valuation of variations but can be central to claims concerning delay, disruption and defects.
- **Variations: Middle East civil codes:** this article considers the application of provisions in the UAE and Qatar codes as they relate to variations.
- **Restrictions on the power to vary:** an employer's right to alter the scope will be restricted in various ways – principally in terms of the type and volume of variations that it may introduce as well as the timing of any instruction.
- **Procurement law restricting variations:** this article considers recent changes to EU law and how this may affect the power to instruct changes to scope.

Further details about the book can be found on our website: www.hfw.com/Construction-Contract-Variations

The authors' royalties from the book are being donated to the construction industry charity, The Lighthouse Club. More information about the excellent work it undertakes can be found on the charity's website: www.lighthouseclub.org

The inside back page of this Bulletin contains a listing of the events at which the members of the HFW construction team will be speaking over the coming months.

Should you require any further information or assistance on any of the issues dealt with in this Bulletin, please do not hesitate to contact any of the contributors or your usual contact at HFW.

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Change at the centre of disputes

Our new book, *Construction Contract Variations*, is the only current text that deals exclusively with the subject of changes to the scope of works on a project. This is surprising in view of the wide range of disputes which turn on issues that relate to variations.

Change to the scope of works is at the heart of most disputes on construction projects. At the most basic level this leads to disputes about variations themselves – which can involve disagreements about the valuation of a variation or even whether the work is a variation at all. Such disputes are what we would generally regard as forming the typical variation account.

Disagreements about variations will also be at the centre of disputes that fall outside the variation account, such as those concerning delay, disruption, defects and termination. The very question of whether an item of work is within the contract scope that the contractor is obliged to undertake, or whether it is an extra, is at the heart of many of these other disputes. Delay may have been caused by certain works, but whether this is the employer's responsibility or the contractor's will depend on whether it forms part of the contract scope. The same goes for loss and expense claims where disruption has been caused to the works as a result of alleged "extra" work.

Such disagreements about what the scope of work consists of will also lie behind disputes concerning defects. For example, the correction of a defect will often involve changing the design. But the parties will often disagree as to who is responsible for the change. The employer may argue that the contractor's scope includes responsibility to change the design to the extent that it is defective, and that therefore this extra work is within its scope and not a variation. On the other hand, the contractor may argue that it is only obliged to undertake the works as described in the technical documents and that the design change represents a variation.

In many of these situations a stand off can arise between the parties. After all, a contractor will typically not be entitled to be paid for extra work undertaken unless it has been formally instructed in advance. The contractor may therefore refuse to undertake the item of work in question unless and until the appropriate variation order has been issued. If the employer refuses to issue the variation instruction on the basis that the work is within scope (and therefore not required), an impasse may arise. In extreme circumstances progress may be halted – leading, in turn, to allegations of contract repudiation or termination.

The legal issues that relate to variations have implications that stretch far wider than the traditional variation account.

Our new book on variations is intended to fill a clear gap in the market. Whilst there are several books on other specific construction law topics (such as delay, disruption, defects and design), there are no current texts on variations despite this being such a common source of disagreement.

The book therefore analyses in detail the way in which the courts and other tribunals will examine inconsistencies and errors in the contract scope of work when seeking to determine whether certain work is within a contractor's obligations. It considers the extent to which design responsibility compels a contractor to carry out extra work that is not specifically referred to.

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MICHAEL SERGEANT

The employer's right to change the works is examined and the degree to which this may be curtailed because the nature of the extra work is beyond that envisaged by the parties. The book considers what constitutes a variation instruction and the extent to which the contractor may be able to establish a claim for extra money and time in the absence of a formal order.

We hope that the book will help those in the industry who are engaged in seeking to resolve problems concerning variations – whether this is a humble variation account or a major project failure which has at its heart a disagreement about the scope of the contractor's work.

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Variations: Middle East civil codes

Both common law and civil law systems try to ensure that contractors are properly compensated for variations that are implemented even in the absence of an instruction.

Civil codes will often contain provisions to regulate how variations should be treated. For example, the Qatar Civil Code, at Article 709 states: *"Under a lump sum contract to undertake works to an agreed plan, the contractor may not seek any additional monies because of some alteration or addition to the plan, unless it can be attributed to an act of the employer or the employer has authorised the change and has agreed with the contractor its entitlement."*

The UAE Code, at Article 887, contains similar provisions, providing that the contractor cannot demand additional payment in the carrying out of works unless the employer has consented to changes.

The principles articulated in these codes would be instantly recognisable to an English lawyer. However, the devil is in the detail – whilst the Qatar Code says that no right to compensation is due unless the employer has caused or authorised the change – there is considerable scope for debate as to what may constitute such causation or authorisation.

Two particular problems commonly arise. Firstly, an employer may informally indicate that it wants a change to be made without actually issuing a formal order even though this is required under the contract. Secondly, an employer may be responsible for events or risks which give the contractor no option but to alter the works.

If the employer has informally told the contractor that it wants a change made then it will seem unduly harsh to deny the contractor a remedy just because a formal order has not been raised. The courts in common law jurisdictions will often invoke the concept of waiver or imply a term to establish the contractor's entitlement. Civil law jurisdictions will often invoke concepts of fairness and good faith to achieve an equitable result. They will also typically provide that the common intention of the parties and the nature of dealings between them may be looked at when considering how the express terms of the contract should be interpreted (see, for example, the Qatar Code article 169).

Suppose, for example, an employer refuses to issue a variation order because it considers that an item of work is within the scope. At a later stage the contractor establishes conclusively that the employer was wrong and that the item of work was indeed extra. The employer may then refuse to pay for the work on the basis that no formal order was issued and therefore, under the terms of the contract, no money is due. Cases in common law jurisdictions have relied on concepts of waiver to give the contractor a remedy; see, for example, the Australian case *Molloy v Liebe* (1910) (102 LT 616 PC) which was determined on very similar facts to these. Where the contract is subject to civil law then a tribunal is likely to invoke concepts of fairness in the way it interprets the contract and the dealings between the parties.

The other problematic scenario arises where the contractor has no option but to implement a change because of an event or risk that is the employer's responsibility. For example, the employer's design proves to be unbuildable such that the contractor has no option but to make alterations if the project is to be completed. It may be possible to imply an obligation on the employer to vary the works in such circumstances and the English courts have certainly considered that such a duty may arise (see *Holland Hannen v WHTSO* (1981) 18 BLR 80). Certainly Article 709 of the Qatar Code indicates that a contractor may be entitled to payment for additional work in the absence of an instruction where the need for the change can be attributed to an act of the employer.

It can therefore be seen that both common law and civil law systems seek to find equitable solutions to common problems concerning variations even though there may be differences in the way such rights and remedies are expressed.

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ROBERT BLUNDELL

Restrictions on the power to vary

An employer's contractual right to vary the scope of the works will normally be subject to express or implied restrictions. This article examines these restrictions as well as the limitations on the omission of work from the scope.

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HUW WILKINS

Contractual obligations cannot be varied unilaterally unless the contract contains express provisions. An employer will often want, or even need, to change the scope once the works begin. It would be unrealistic to work on the basis that such changes can be negotiated and so an employer needs the power under the contract to order the changes it wants.

However, an employer's contractual right to vary the scope of the works will not be unlimited. It must be exercised in accordance with certain contractual restrictions, which may be either express or implied. These restrictions can broadly speaking be divided into 3 categories: (a) restrictions regarding the type of change; (b) restrictions regarding the volume of change; (c) restrictions as to when an employer may instruct a change. This article examines each of these restrictions. We also look at special considerations in relation to the omission of work from the scope and where an employer wants to bring a new contractor on to the site.

(a) Type of Change

Neither party to a construction contract will know, on entering into the contract, what changes will subsequently be necessary or desired. Accordingly, an employer will want a wide discretion as to the variations it can instruct. On the other hand, the contractor is signing up to undertake a specified scope of works and may have good commercial reasons for wanting to refuse to undertake certain additional types of works not contemplated by the scope.

Express restrictions as to the type of changes an employer may instruct are relatively uncommon in standard form contracts, although they do exist. For example, the ICC Measurement Version 2011 Form of Contract permits only the instruction of variations which are desirable for completion or the improved functioning of the works.

Similarly, the ENAA 2010 Form of Contract permits an employer only to instruct a variation which *"falls within the general scope of the Works and does not constitute unrelated work and that it is technically practicable, taking into account both the state of advancement of the Works and the technical capability of the change, modification, addition or deletion with the nature of the Works as specified in the Contract"*.

In contrast, the FIDIC Silver Book entitles the contractor to object in specific instances, being where (i) it cannot readily obtain the Goods required, (ii) the safety or suitability of the Works will be reduced, or (ii) the achievement of the Performance Guarantees will be adversely affected.

Both the ENAA and FIDIC Silver Book are contracts where the contractor takes significant design risk. Under such contracts it is important that the contractor has the right to refuse to undertake instructed changes because the proposed alteration may undermine the integrity of the design for which it is responsible. The right to veto a variation under these contracts is therefore often linked to deficiencies in the technical validity of the proposed change.

(b) Volume of Change

A contractor will normally be willing to undertake variations because such work will be profitable. However, a large number of changes may be difficult to resource. They may delay completion of the project in circumstances where the contractor needs to move resources onto a new job. However, express restrictions on the amount of variations that may be instructed are rare.

The MF/1 form of contract (intended for projects involving supply and installation of electrical and mechanical plant) is one example. It includes a cap on the value of variations which the employer may instruct. The cumulative value of variations may not amount to a net



change to the contract price of more than 15%.

Rather than imposing a strict percentage cap on the value of permitted variations, the Norwegian Fabrication Contract (NF/07) which is used in the oil and gas industry instead prohibits the employer from instructing variations which cumulatively exceed that which the parties could reasonably have expected on entering the contract.

Each of these approaches has its own limitations. The rigid 15% might prove obstructive where a change is necessary, whilst the NF/07 can be uncertain in its application. After all, what the parties could reasonably have expected on entering the contract may be far from clear.

(c) Timing of Change

The timing of a variation will impact on the progress of the works. A variation instructed during the design phase will not have as much of an impact as the same instruction issued during construction. Generally speaking, the later a variation is instructed, the more disruptive and costly it will be.

In recognition of this, the ENAA Contract states that an employer's right to instruct a variation depends upon the *"state of advancement of the works"*. This is quite an unusual approach and most forms of contract adopt a specific cut-off date for variations.

The FIDIC Red, Yellow and Silver Books permit the instruction of variations prior to the issuing of the Taking-Over Certificate. Such an approach is understandable because following this certification the contractor will demobilise and hand over the site to the employer.

Where a contractor is appointed to design, build, operate and maintain a facility then, perhaps understandably, it would be inappropriate to effectively sever the employer's right to instruct variations upon completion of the build period. The FIDIC Gold Book recognises this and permits the employer to continue to instruct variations throughout the operational phase.

Omissions

A construction contract not only obliges a contractor to carry out the defined scope of work, but also entitles the contractor to undertake the work in exchange for the contract price. Whilst the variations clause may allow the employer to omit work from the scope, it cannot take advantage of this power to effectively re-write the parties' commercial bargain. After all, the contractor has negotiated a contract price on the basis of a certain volume of work and if that is dramatically reduced the project may become uneconomic.

Most legal systems therefore imply limitations on the employer's power to omit, such that it may not take work out of the contractor's scope and re-distribute it to other contractors. However, this is normally imposed as an implied restriction and is therefore subject to express terms to the contrary. An employer might therefore be able to omit works and re-distribute it if express wording is included in the contract providing for this.

Supplementing the contractor

There is no implied obligation that an employer must instruct the original contractor to undertake extra work on a project. The employer may instead want to bring a new, additional, contractor onto the job and there is no reason in principle why the employer should not do this.

However, in following such a strategy, the employer may breach the rule concerning the omission and re-distribution of works discussed above.

Whether the introduction of a new contractor puts it in breach of the "omit and re-distribution" rule depends on the nature of the change. If the re-design involves the change of materials then it may well be caught. For example, suppose the construction of a building involved a particular type of flooring. If the employer changed the specified flooring material and brought in a new contractor to undertake the work then it is likely that a tribunal would find that this violated the rule about omitting and re-distributing. However, an employer would probably be free to bring a new contractor onto the project to undertake a new added element of work following a substantial re-design.

The contract with the original contractor may, of course, place express restrictions on the employer's power to bring a new contractor onto the job by giving it exclusive possession. Safety management issues will also need to be considered. An employer should always be cautious about such a strategy because of the risk of delay and disruption claims where there are parallel contractors on site.

Conclusion

Variations mechanisms giving the employer the freedom to alter the scope unilaterally are a commercial necessity. They are included in construction contracts in order to allow the employer the flexibility it requires to take account of unexpected site conditions or commercial developments during the lifespan of a project. However, such powers are often subject to implied limitations. In addition, contractors will also insist on restrictions to the power to vary in order to safeguard their commercial interests.

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hfw Procurement law restricting variations

Changes to EU law will soon mean that employers may be prevented from instructing sizeable variations and will instead have to tender such works via a new contract award.

Since the early 1990's any public body or utility company tendering a substantial construction contract has had to do so in accordance with certain statutory procedures which seek to ensure that all contractors have advance notice of projects they may want to bid for. These procedures stipulate an open and transparent tender process which is conducted by reference to a clear set of criteria. A contractor can challenge the award of a contract if the public body does not follow the rules.

In recent years, the EU has been concerned with a possible loophole in the regulations relating to variations to construction contracts. Suppose a government contract is let for the construction of a 200 km stretch of railway and tendered in accordance with the usual procurement rules. Then, part way through the project, the public rail authority decided it wanted to extend the track by a further 75 km. If the project was let as a new contract it would need to be tendered in accordance with the public procurement procedures. But, could the additional track package instead be instructed as a variation to the original scope thereby avoiding the delay involved in running a new tender process? Other contractors might object that they couldn't pitch for the work which was instead given to the incumbent contractor – perhaps at an above market price.

...a failure to correctly follow public procurement rules can have severe consequences. Disgruntled contractors, unable to bid for the work, may have the right to challenge the variation through the courts.

MAX WIELICZKO

A legal challenge by an Austrian company to an agreed variation of a contract in the ECJ in 2008 has spurred the EU into passing a new directive, which came into force on 17 April 2014. The UK government is required to introduce legislation to implement EU directive rules within the next two years, which will extend the reach of procurement law with significant implications for the operation of construction contracts.

The new rules are complex, but in short they will prevent public bodies from instructing major variations and ensure they instead run a new tender process in which all interested contractors can compete. Small variations with a cumulative value of up to 15% of the contract value will not be caught by the rules. The directive separately provides that variations which are not "substantial" will be allowed. In order for a variation to be challenged it must be substantial and the 15% ceiling must have been exceeded.

There are further exceptions designed to ensure that employers do not become unreasonably constrained by these new regulations, and can still instruct major changes even if they infringe these two rules. For example, one exception is where additional works are necessary, but a change of contractor is not possible for economic or technical reasons. This could apply in a technically complex project where the integration of varied equipment means that bringing in a new contractor is not feasible. A further exception arises in the case of an unforeseeable modification which does not alter the nature of the contract and amounts to less than 50% of the contract value.

Many of these exemptions to the new rules are quite vague – for example, it will be subjective as to what constitutes a "substantial" variation. An employer's decision to instruct a variation or a contractor's legal challenge of that decision may turn on what this entails. This is unfortunate because a failure to correctly follow



public procurement rules can have severe consequences. Disgruntled contractors, unable to bid for the work, may have the right to challenge the variation through the courts. They may be able to force the employer to follow an open tender process or demand compensation.

Therefore, whilst the legislation is necessary in order to close a loophole in the public procurement rules, this legislative change will open up further uncertainty in an area that is already a potential minefield.

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hfw Conferences & Events

Society of Construction Law
National Liberal Club, London
3 June 2014
Presenting: Michael Sergeant

Hong Kong Institute of Surveyors
Apportioning Risk – Liabilities, Losses and Limitation Clauses
Hong Kong
5 June 2014
Presenting: Nick Longley

Akolade: Construction Law Masterclass
Sydney and Melbourne
21 July and 24 July 2014
Presenting: Nick Longley and Brian Rom

IBC Construction Law Summer School
Variations under FIDIC contracts
Cambridge, UK
2 September 2014
Presenting: Michael Sergeant

Society of Construction Law
Birmingham, UK
9 September 2014
Presenting: Michael Sergeant

Launch Party for *Construction Contract Variations*
HFW London offices
10 September 2014
Attending: Book authors, Michael Sergeant and Max Wieliczko

LNG Seminar
Brisbane
18 September 2014
Presenting: Nick Longley and Matthew Blycha

MBL Construction Law Conference
Buildability and Design Risk
London
23 September 2014
Presenting: Michael Sergeant

Hong Kong Society of Construction Law
Hong Kong
13 November 2014
Presenting: Michael Sergeant and Nick Longley

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