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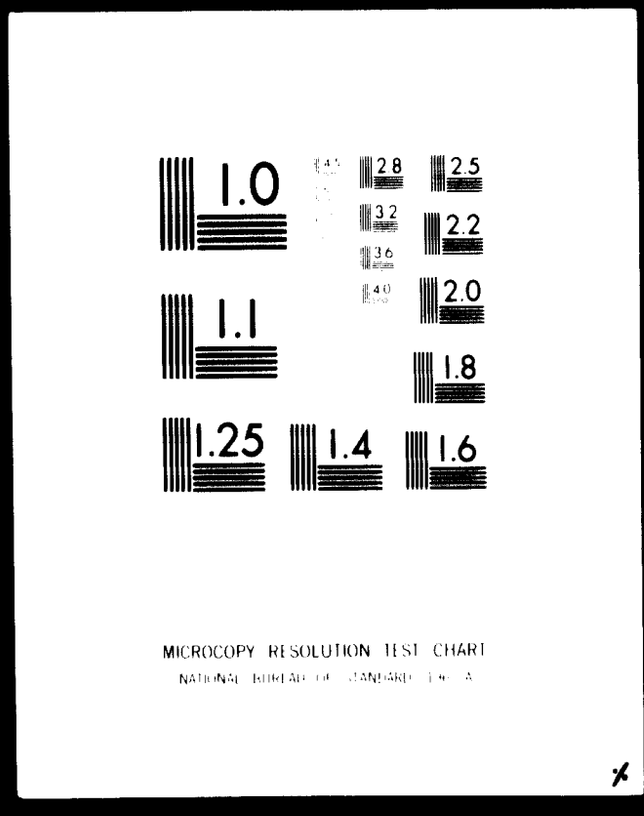
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Lahore, Pakistan, 25 – 29 November 1977

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UNIDO/BIM SEMINAR - LAHORE

THE CONTRACTOR'S VIEW OF CONSEQUENTIAL LIABILITY

by

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ENGLAND

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THE CONTRACTOR'S VIEW OF CONSEQUENTIAL LIABILITY

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It will not surprise anyone to be told that the concept of consequential liability is unacceptable to the Contractor. Anyone who has used the services of a Contractor to build a plant will know that no reputable Contractor will accept liability for consequential damages in his contract.

It may seem unreasonable to some that a party who defaults should not suffer the full consequences of his actions but I wish to demonstrate that this is eminently reasonable. I also want to go on to make the point most emphatically that this attitude does not mean that the Contractor is irresponsible or diffident. On the contrary he must accept a role of greater responsibility because of this and one of constructive cooperation with the Purchaser.

The Purchaser is the enterpreneur and his decision to build a new plant involves many risks and is fraught with many hazards. Large sums of money must be invested and considerable resources employed to fulfil a distant aspiration. Many things can go wrong with the project after the decision has been made. For instance the market for the product may change, the expected feedstock, utilities and other facilities may not become available as anticipated, unexpected difficulties of all kinds may appear and even unusually bad weather can severely affect progress. Shortcomings in the performance of the plant is only one of the

risks that is run. Even if a Contractor does have difficulty in fulfilling his obligations, and this is by no means as common an event as might be supposed, he should not be expected to pay for all of the consequences of failure when his responsibilities form but one part of the total risk which the Purchaser has decided to run. Also, on the rare occasions that a Contractor does run into trouble, it will be unusual if other problems outside his control do not also afflict the Purchaser and therefore make an apportionment of blame very difficult if not impossible. In taking a commercial decision to build a plant the Purchaser risks making a profit or a loss. He will not offer to share the profits of a successful venture with the Contractor on the quite justifiable grounds that the Contractor is only responsible for one area of input and invests none of his own capital. Likewise he should not expect the Contractor to bear or even share the losses of an unsuccessful plant for the same reasons.

A Contractor has finite resources of his own and for the most part makes only a small profit on his turnover. He simply does not have have the wherewithal to pay consequential damages. If he is quoting a fixed price he will include small contingencies to cover a variety of risks. The greater the number of risks he has to shoulder the higher will be his price. The Purchaser who makes the greatest demands will in the long run pay the highest price. Even then the Purchaser will not get the Contractor to accept full consequential damages as no price could include a risk which is not finite and is outside the Contractor's ultimate control.

The type of contract will in fact determine the liability that a Contractor can undertake. For a lump sum contract a Purchaser will expect the Contractor to take a variety of risks such as the price of his equipment, performance guarantees and warranty obligations. However, for a reimbursable contract where the Purchaser pays the net cost and where there is no opportunity for the Contractor to include contingencies a Contractor is able to absorb only the minimum of risks and the rest must be the

responsibility of the Purchaser. In the extremd instance where the Contractor places all orders as an agent, for and on behalf of the Purchaser, a relationship which is becoming increasingly common, the Contractor is acting as an extension of the Purchaser's own organisation. In such cases the Contractor has the role of an employee who may be dismissed if he fails in his duty but is not asked to pay penalties. Contractors like employees will not be forthcoming if they are expected to pay for their mistakes under these circumstances.

Consequential losses are invariably seen as those suffered by the Purchaser. It should also be remembered that the Contractor runs the risk of severe consequential costs of his own. If he has made a miscalculation in his estimate or has to put right faulty work the cost to him can be considerable. As contracts get bigger, and US $250 millions is no longer a novelty to us, a small percentage error can have dramatic consequences. It is enough for the Contractor to run such risks, assumed as much for the Purchaser's sake as for his own, which are under his own control. There is no way in which he can be responsible for paying for costs over which he has no control and which are purely a function of the Purchaser's own commitments. If the Contractor were called upon to accept unquantifiable and unseen costs he would be deterred from bidding at all.

Closely related to the concept of consequential liability is the "On Demand Bond" which is also unpalatable to the Contractor. The only reason why he does from time to time accept such bonds is that the competition may be severe and there is at least a finite limit to their consequences. But the concept of such a bond is based on a pessimistic view of the Contractor's role which is rarely justified.

Bid bonds of any kind we believe have no constructive purpose to play in protecting the Purchaser's interests. A serious Contractor has to make a considerable investment himself in bidding for and negotiating a contract and would never withdraw from the

competition for frivolous reasons. If he does withdraw it can be said with certainty that the reasons are likely to be due at least as much to the Purchaser as to the Contractor and the Contractor should not be under pressure to continue an unwanted negotiation for the fear of losing his deposit. A heavily claused Bid Bond is a compromise which we follow ourselves but an On Demand Bid Bond is totally unjustified and unacceptable.

The practice of requiring "On Demand" Performance Bonds is likewise to be regretted. The true purpose of a bond should be to give the Purchaser security for payments to which he is contractually entitled. It is a third party guarantee of payment. The growing practice of seeking to use bonds as a hostage against the Contractor puts the Contractor at an unfair disadvantage. There should be no place in a contractual relationship for a Purchaser to take arbitrary action against a Contractor or to threaten to do so. Any Performance Bond of over 5% will exceed the Contractor's profit and to be under the constant threat of losing all that he has worked for at the whim of the Purchaser can only have the effect in the long run of putting up the price to the Purchaser or driving away Contractors.

You have heard at some length what the Contractor is not prepared to do but if you are a Purchaser you will be aware that for various reasons, sometimes the fault of the Contractor, consequential losses will be suffered. What is the answer to this and what positive protection does the Contractor have to offer?

In the first place we cannot do better than endorse the view expressed at the First Consultation Meeting as follows:

> "One of the best forms of insurance would be to select carefully reputed and experienced Contractors, adopt prudent technologies and equipment and ensure that contracts contained appropriate guarantee clauses".

A serious Contractor will not put himself forward if he does not consider that he is capable of fulfilling the trust placed in him. The penalties of failure go far beyond the payment of damages and a Contractor who fails to perform or who takes an unfair advantage of the Purchaser will seriously prejudice his future in the market place. Loss of credibility is the greatest penalty a Contractor can pay and fear of this is the chief incentive to any Contractor. The Contractor's reputation is probably the Purchaser's best protection.

The Contractor will of course undertake a variety of specific liabilities. He will warrant his own engineering and repeat faulty work free of charge. If he is responsible for purchasing the equipment as Principal he will take responsibility for delivering on time, for the quality of packing and for the workmanship and materials for a period usually up to 12 months from start-up. If he is using his own know-how or acting as the vehicle for someone else's he will usually also guarantee the plant for quality of production, output and consumption of utilities and feestock.

It is normal to give the Contractor some incentive positive or negative to fulfil these obligations.

Positive incentives are infrequent in the Fertilizer Industry and occur usually only as a bonus clause in juxtaposition with a penalty clause when time of completion is the essence.

Negative incentives which are much more common consist mainly of penalties for late delivery of equipment and documentation, for late completion and for shortcomings in guaranteed performances. Not every contract needs all of these and the Purchaser should only select those which are essential to him. Too luxurious an insistence on penalties can only force the Contractor to increase his contingencies and price. A Contractor will always seek to limit these damages, as a negative incentive must not cripple genuine attempts to improve performance. The Contractor will often support these obligations with a bond but this should be seen as a guarantee of payment only and for the reasons described earlier

should not expose the Contractor beyond the extent of his obligations.

It is an essential principle of a Contractor that such penalties as are agreed to be paid under the contract should be liquidated damages relieving the Contractor of his further obligations for the breaches of contract he has committed. Consequential damages are invariably specifically excluded.

Whilst any liquidated damages payable may make some small contribution to the Purchaser's actual losses that is not their intent. They are provided for as incentives and not as compensation, and therefore should not be confused with consequential damages which the Contractor will reject.

Any Contractor and Purchaser knows, however, that faults will occur and accidents will happen which impair the successful and timely operation of a plant and therefore it is important to guard against such happenings and to find ways of protecting the Purchaser against the full effect of costs which will arise.

Nothing is more important than making all the correct preparations and making a realistic assessment of what is needed. The greater the care that is taken at the outset the less likely are the chances of costly problems thereafter. This cannot be stressed too much as wrong decisions at the outset are difficult if not impossible to reverse and there is no substitute for sound planning. Many of these have nothing to do with the Contractor's own role. It is important that a Purchaser is sure about the products he wants to make and about the market he wants to serve. It is important that he chooses his site carefully with reference to all physical and economic factors. It is important that he has a full understanding of the availability of feedstock, utilities and construction and operating skills. If miscalculations are made in any of these areas both the Contractor and the Purchaser will incur substantial costs coping with adverse situations which are beyond the control of both of them once a course of action has been decided upon. If there are any doubts in these areas the plant

should be designed to withstand the tolerances imposed by such uncertainties and engineered to give maximum scope for the imponderables that might be encountered. The greater the risk of these eventualities the less sophisticated the plant should be. All this must seem extremely obvious but it is the Contractor's experience that insufficient care over such matters are frequently the greatest cause of problems during the construction and commissioning stages of a project.

So far I have said little about insurance, but this is because I have wanted to stress that there is no substitute for the proper ordering by the Contractor and the Purchaser of those matters which are under their respective control to avoid losses. Insurance is not normally provided to compensate people for their thoughtlessness or folly but is there to protect innocent parties against unforeseen and accidental losses. The unforeseen and accidental do however constitute a very large part of the risks which both Contractor and Purchaser run in the building of a plant and the skilful use of insurance to guard against these risks is one of the arts of contracting. It should be the subject of a close and frank cooperation between the parties concerned. The construction of the most comprehensive insurance protection possible is a skilled job which should not be underrated.

The standard insurance package to guard against direct losses will normally consist of the Contractor's own Employers Liability Insurance, Marine and Transit Insurance taken out by either the Contractor or Purchaser depending upon their respective contractual responsibilities, a Contractor's All-Risks Policy which should include third party cover and insurance through the defects liability period and the Purchaser's own Fire and Explosion Policy to cover existing plant and the operating risks of the new plant once it is commissioned. In addition there may be a number of policies covering motors, baggage, etc. A number of parties such as the Contractor, his Sub-Contractors, the Purchaser, local

Construction Companies and others will all be on site at one time or another and therefore policies should, wherever appropriate, include their interests too and waive subrogation against them. Such refinements cost little if anything more and by avoiding the need for all parties to take out supplementary insurances of their own will lower the cost of the plant. They also make it much more convenient and speedy to prosecute claims and have them paid. The fundamental rule should be that where insurances can be taken out against the risks incurred in building a plant they should be purchased as they will invariably be cheaper and less troublesome than attempts by Contractor and Purchaser to get each other to bear the responsibility for such risks. For example, it is counter-productive to ask a Contractor to take responsibility for costs incurred on site due to faulty instructions where this only has the effect of encouraging him to raise his price when the risk can be perfectly adequately covered by the CAR policy.

There will be certain risks that are excluded from CAR policies covering direct losses such a war, riots, radioactive contamination, etc., and which it is only reasonable that the Purchaser should himself bear. The Contractor will also often consider that he is unable to bear specific excesses imposed by the insurers, particularly those of the Purchaser's national insurance companies. Finding insurance to cover consequential losses is however a completely different matter. Consequential losses are by definition indirect and establishing the cause and quantifying the cost of indirect losses presents severe difficulties.

There is one kind of consequential insurance which is fairly common and that is insurance for business interruption consequent upon fire and explosion perils. Such insurance is not meant to compensate against indirect losses at large but to enable an afflicted party to maintain an on-going business whilst the basic damage is rectified. This kind of cover can be extended to

situations where damage has occurred on site and where delays have resulted from site accidents and these covers may be valuable to purchasers depending upon the degree to which such events might disrupt completion dates and profit expectations. It has to be recognised however that such insurances are for the benefit of the purchaser only and therefore the risks which they are covering must be excluded from the Contractor's liability for he has no means of attaching the benefits of such insurances to himself.

It is questionable whether consequential loss insurance can be expected to reach further. We, as Contractors have for some years investigated the possibility of insuring ourselves against consequential losses which we may be subjected to internally, but have not found a satisfactory market for such insurance. This is basically because the Insurance Market does not see it as its function to absorb the risks of otherpeople's shortcomings and errors, particularly as these are difficult to measure and the existence of such insurance is likely to discourage sound practices. Equally we think it is unlikely that the Insurance Market could be persuaded to accept cover for consequential losses which lie within the Purchaser's area of responsibility.

I certainly believe that further exploration should continue, probably along the lines suggested by Dr. Raistrick, but it may take a long while to achieve success and even then the number of cases where cover would prove effective might be few. This activity should however not be seen as a substitute for establishing sound principles of contracting in which direction the energies of all concerned might be more profitably employed, certainly in the short term.

Dr. Raistrick has in his paper drawn attention to the Model Form of Contract for Process Plants issued by the Institution of Chemical Engineers in London. So far these conditions are drafted for UK Contracts only, but an International

edition is in prospect. These contract conditions can certainly be recommended as a check-list for the kind of provisions which should appear in any contract for a Fertilizer Plant and the descriptive guidelines which appear together with the Model Form are themselves a valuable commentary upon what is possible and what is reasonable. The day may never dawn when all contracts for Fertilizer Projects are subject to uniform principles and practice recognised internationally as protecting the interests of both the Contractor and the Purchaser. Indeed this is probably not a wise objective as every project has its own peculiarities and a tailor-made contract for each project would probably serve its purposes best. I would however hope that in time these conditions would play a greater part in guiding both Contractor and Purchaser alike along the path of improved contracting principles and practice in a spirit of cooperation towards a common objective. I believe that if this happens both Contractor and Purchaser will benefit and the incidence of losses, whether direct or consequential, will diminish, thus substantially reducing and hopefully eliminating the problem which we are here to discuss.

London, 24th November 1977.

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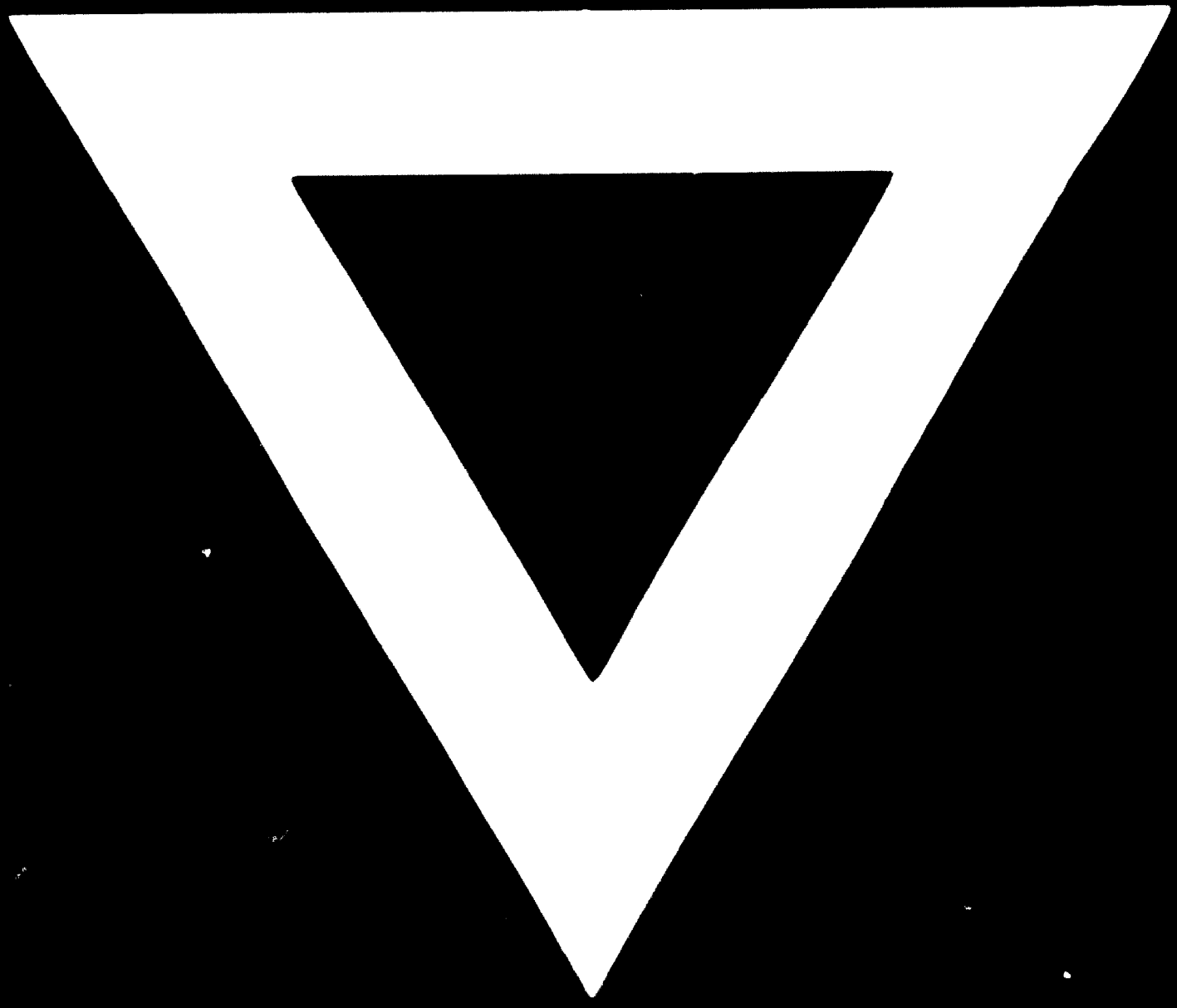

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