1 Contract

1.1 What is a contract?

We can say that a contract is an *agreement between two or more parties which gives rise to rights and obligations which will be enforced according to the system of law applying to the contract*.[1]

A simple example is where A and B agree that A shall build a house for B for a fixed price according to plans prepared by B's architect. Under this contract, A will have both an obligation to build the house according to the plans and a right to payment of the price when the work is done. B will correspondingly have both the obligation to pay A and the right to have the house built according to the plans.

Depending on which system of law applies to their contract, if A does not fulfill his obligation to build the house according to the plans then B might be able to obtain compensation for this 'breach' or breaking of the contract. The system of law applying to the contract might say, for example, that B is entitled to obtain a sum of money sufficient to put him in the position in which he would have been had the contract been properly performed, that is, had A in fact built the house in accordance with the plans; this sum of money could be the cost to B of rectifying A's deficient work.

The way in which B would actually go about obtaining the compensation to which he would be entitled according to the system of law applying to the contract depends upon a number of circumstances, and could be quite

[1] Often the system of law applying to a contract, also called the governing law of the contract, will be stated in the contract itself. For example, the parties may include a clause in their contract which provides for Chinese law to apply to their contract, or for English law to apply. See page 80 for an explanation of what is meant by the system of law 'applying to' or governing a contract.

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complicated. In a simple case where A and B both reside in the same country and have their assets there, B will typically go to the local court to obtain an order against A for the relevant compensation. If A does not pay, then B may be able to 'execute' his order by obtaining other orders against A to force him to pay; for example, an order for the sale of A's assets. In a more complicated case, where A and B live in different countries, or A's assets are in a different country, the procedures for executing his order for compensation against A could be more complicated for B.[2]

Let us look more closely now at what is meant by an agreement between two or more parties giving rise to a contract between them.

1.2 Agreement

When we say that a contract is an agreement, that does not mean that the parties need to have reached agreement on all the details that concern their project. Many systems of law will give effect to contracts in which only certain matters, regarded as essential to the contract, are agreed.[3]

Nor does 'agreement' necessarily mean actual agreement or a meeting of minds, in a psychological or subjective sense. Many systems of law will find that the parties have made a contract containing certain terms, even though one or other party might not actually have assented to those terms. As long as the parties have acted towards each other in such a way as to lead a reasonable third person observing them to conclude that they had agreed certain terms, then they will be held to have done so and be bound accordingly.[4]

Many systems of law also distinguish between the agreement or contract itself and the sometimes lengthy negotiations leading up to the agreement. Once the contract is formed, the terms of the contract are what bind the parties and create the obligations and rights which may be enforced. The discussions or negotiations taking place beforehand will not be taken to form part of the contract. In some legal systems they may not even be used in order to interpret the terms of the contract, although some systems may permit the factual background to the parties' transaction to be used to interpret the words of the contract where they are ambiguous or uncertain.

This distinction between the agreement itself and the negotiations leading up to it highlights the importance for each party to the contract to identify

[2] Those steps could, for example, involve first obtaining an order against A in the courts of the country in which the work was carried out or sited and then applying, relying on that order, to the court in the country where A's assets are situated.

[3] For example, in some systems of law it is essential that the parties identify with certainty what works are to be performed but not the price to be paid. In such a case the relevant court might order that a 'reasonable' price be paid.

[4] Such a criterion for determining whether parties have 'agreed', in the sense of a contract, to particular terms is common to many legal systems and is sometimes called an 'objective' test of contractual agreement.

clearly what are the terms agreed between them which will bind each of them, and to make sure that various other matters, which might have been discussed but had been abandoned or modified in the course of the negotiations, are clearly distinguished from the terms of the contract itself.

1.3 Do contracts need to be in writing?

It is sometimes thought that you cannot have a contract if there is nothing in writing; that there has to be a document, signed by both parties, with perhaps other formalities as well.

But this is not always the case. Whether a contract needs to be in writing depends on the system of law that applies to the parties' transaction. Sometimes, a legal system will require a written document; for example, in contracts concerning the sale of land many legal systems require a written contract. In other cases, the contract could be contained entirely in oral or word-of-mouth exchanges, without the need for any writing. These contracts could be just as binding as written ones.

It is true that in a construction project of any size you will normally have a written contract; this will not only be written, but will typically be a very detailed contract setting out the parties' rights and liabilities. However, the possibility of oral or non-written contracts should still be borne in mind. In some systems of law, such contracts might even be found to exist alongside written contracts in certain cases. Parties who wish to avoid uncertainty and ensure that there are only written terms of their contract will need to obtain legal assistance in drafting their agreements. It is also important to note that in some legal systems you might have a contract which arises from a mixture of oral agreements and agreements recorded in informal exchanges between the parties, such as faxes, letters, e-mails or minutes of meetings.

1.4 Other elements of a contract

We have seen that a contract involves an agreement between two or more parties, but what more is needed before the parties are bound by a contract? This question arises because, in many systems of law, it is not enough for the parties to reach agreement in order for a contract to exist between them; other conditions need to be met.

In English law, for example, which applies to many projects with no particular connection with England, the contract is seen fundamentally as a kind of bargain, where one party confers, or promises to confer, some benefit on the other party in return for some benefit or promise of benefit to himself. This conferring, or promising to confer, a benefit in return for another benefit or promise is called *consideration*; it is what you get in return for your promise to the other party and, except in certain limited cases, it is necessary before a

binding contract comes into existence in English law. Thus, in our earlier example of the simple contract where A agrees to build a house for B according to B's plans for a fixed price, B's promise of payment of the price is consideration for A's promise to build the house according to the plans, and makes the agreement a binding contract.

If the system of law applying to the contract requires consideration, this will seldom be in issue where you have a construction contract; in such cases, it is normally obvious what the consideration is.

Other requirements for a contract could include certain formalities; in contracts involving certain subject matters the system of law applying to the transaction might require the contract to be set out in a formal document, with the seal or stamp of the parties to the contract. Specialist legal advice will be needed in order to ensure that the parties' agreement complies with any formalities necessary before it becomes a binding contract.

1.5 Capacity and authority

Let us imagine that you have been negotiating with representatives of a party to a project for the design and construction of a chemical plant in the Gulf; you are the French design-build contractor, and the other party is a Korean joint-venture owner. You and the owner's representatives have recorded in detail the terms of the intended contract between you in a formal document. After much discussion, the details of every aspect of your agreement have been reduced to writing, and everything appears ready now for the signing, or 'execution', of the contract. The other side's senior representative and you then both duly sign the contract in each other's presence.

Now you think that you have a binding contract. However, you might not have a binding contract if the person who signed the contract for the other party was not authorised to do so.

One very important, but sometimes overlooked, feature of contracts in general concerns the authority of the person signing or executing the contract on behalf of the named party. Does that person truly have power or authority to bind the named party by signing the contract, apparently on its behalf?

This question arises most commonly in connection with companies or corporations rather than with individual people. Most legal systems contain rules for the formation, constitution and regulation of companies or corporations; they are treated as legal persons, just like real people, having legal rights and obligations themselves and being able in particular to enter into contracts in their own names. So 'A Ltd.', or 'A Corporation', or 'A Incorporated' might be names of a distinct legal person, the company or corporation named.

Construction projects of any size will almost invariably involve contracts between companies rather than real people. But because companies are only abstract legal persons, they cannot act except by real people with authority, or

power, to act for them; these authorised people are the agents of the company. So in dealings with third parties, including entering into contracts with them, companies will act by or through their agents.

A company's agents will include a whole range of people, with different levels of authority. Some people may have authority, given by the company, to enter into contracts on the company's behalf but only up to a certain financial limit; others may be able to enter into contracts of any size, but only in certain geographical areas, or where the contract concerns a particular subject matter. Whether, and if so what, contracts a person is authorised to enter into on behalf of a company will depend on the constitution and internal organisation of the company and, more generally, upon the system of law that applies to that company.

If a person is authorised to enter into contracts of a certain size or type, then he may be said to have actual authority to bind the company by executing contracts of that size or type. However, many legal systems also have a concept of *apparent* or *ostensible* authority, whereby a company could still be bound by the acts of a person who does not have actual authority. If a company, by its words or conduct, represents or holds out to the other party that a particular individual has authority to contract with it then it may be open to the other party to argue that the company is bound by the individual who signs the contract, even if that individual lacked actual authority to do so.[5]

This concept of ostensible authority is very important because it is often not possible to tell, without making detailed inquiries of a kind which are not always made, whether the particular person signing the contract is actually authorised to do so. If he has apparent or ostensible authority then, as described above, the company could still be bound.

We have highlighted the distinction between these two kinds of authority because it is surprisingly common in international projects for questions of authority to arise if there is later a dispute. One party might argue that the contract was not validly concluded because the person signing it did not have authority or power to do so on the company's behalf, and in this way seek to avoid a payment or liability. In order to protect yourself from such an argument it is very important to obtain legal advice. Your legal adviser should satisfy himself that the person purporting to execute a contract on behalf of the named party has authority to do so.[6]

Another, related matter of great practical importance is the *capacity* of the company named as the other party to the contract. In some legal systems there is a doctrine or rule to the effect that a contract entered into with a company which, by virtue of its constitution, is unable or lacks the capacity to enter into

[5] Many (although not all) legal systems have a concept of apparent or ostensible authority. The details of this doctrine will vary from system to system.

[6] This could involve examining whether the relevant person has actual authority according to the laws of the country of incorporation of the named party to the contract.

contracts of that kind is null and void and cannot be enforced.[7] Your legal adviser should take steps to ensure that no problems of capacity arise should the project later encounter difficulties.

We shall be looking shortly at BOT or concession-type projects, in which there is a contract or contracts between a government or government agency and another party or parties. In any contract with such a body it is essential to ensure that it has the legal capacity to enter into the contract; special rules could apply to such bodies that do not apply to private entities. In addition, it is important to ensure that the individual or individuals signing on behalf of the official body have authority to do so.[8]

1.6 Importance of a written contract

We have so far been looking at some of the most important features of contracts, and have seen that contracts may vary widely in type, from a very simple oral contract to a highly complex written document. We should say something now about the importance of using a written contract when engaged on a construction project of any size or complexity.

In many cases, parties will take one of the standard forms of contract as a starting point; such contracts will usually set out in some detail the work to be done under the contract, the price to be paid or basis for calculating sums due and generally the rights and responsibilities of the parties to the project.

1.6.1 Clarity and certainty

Perhaps the most important reason for having such a contract is to try as far as possible to ensure clarity and certainty in the parties' respective rights and obligations. As well as the main responsibilities for design, fabrication and the like, these will include such other obligations as provision of performance guarantees and insurance against damage to the works and injury to persons.

The contract should also provide for as many of the circumstances which might arise during a project as possible. These will typically include variations to the works; delay due to unforeseeable physical conditions on site; delay due to adverse weather conditions; testing of the works; and termination of the contract in the event of the default or insolvency of a party, including the financial and other consequences of such a termination.

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[7] This doctrine may be refined in some legal systems to prevent injustice to an innocent third party without knowledge of any lack of capacity; but a prudent party will take steps to ensure that the contract he envisages is one which the corporate party has capacity to enter into.

[8] Also relevant, when dealing with a government or government agency, is whether it can claim sovereign immunity in respect of its activities, including participation in any legal proceedings.

1.6.2 Procedures

As well as setting out the parties' rights and obligations, the construction contract should also provide the parties with procedures to be followed in certain cases or to obtain a certain result. One important aspect of the procedural side of contracts such as FIDIC is that they set out rules for the notification and processing of claims. Thus clause 20.1 of the FIDIC contracts provides that a contractor must notify a claim within 28 days of the time when he became aware or ought to have become aware of the facts giving rise to the claim.[9] This enables the employer to become aware of the claim at an early stage. The FIDIC forms provide a rather less rigorous procedure for employers' claims.[10]

1.6.3 Risk allocation

A properly written construction contract will allocate the risk of loss or damage occurring to the project clearly and completely, so that each party knows precisely which risks he bears and what the consequences are should a risk eventuate.

When two or more parties engage in a construction project, there are many different kinds of risk of which each will need to be aware. These include the following:

- There are *design-related* risks. Does the design for critical parts of the plant or structure, for example, achieve the performance expected? Is it efficient and workable?
- There are risks associated with *site investigations*: geotechnical investigations, for example, where tunnelling or extensive excavation work is required.
- There are risks associated with the *construction process*: the availability of resources and materials, on time, in the right quantities and of the right quality; encountering unexpectedly poor ground conditions even where adequate site investigations have been carried out; the occurrence of unforeseeable events such as bad weather, flooding, and the risk of injury to persons and damage to property; and industrial and political risks, of labour disputes, war, or other civil disturbance.
- There are *financial* risks. Will the employer or owner or developer pay when the work-stages are achieved? What happens if the contractor becomes insolvent before the work is completed?

Only if risk is clearly and completely allocated will each party be able to manage risk efficiently, taking steps to protect against the consequences

[9] See pp. 74–75 for a fuller account of the claims procedure under the FIDIC forms.

[10] See clause 2.5, but here again the employer is required to notify a claim (such as for an extension of a contractual defects notification period) at an earlier stage. The contractor is then in a better position to investigate the claim.

should the risk eventuate. Risk allocation is therefore an essential element of the efficient management of the project itself.

1.7 What should a properly written construction contract cover?

We will look shortly at how risk may be allocated in more detail. But let us look now at the main areas or topics which any properly written construction contract for a project of any size should cover. This will enable us to put much of what we have discussed so far in context.

The terms of a construction contract should at least deal clearly with the following areas:

- Identification of the *parties* to the contract: who (or what legal entity) exactly is the contractor, and who (or what) the employer?
- Identification of the *work or services* to be provided: in which documents or sets of documents are these defined? What *priority* of contract documents should be agreed upon in the event of inconsistencies between the contract documents (often highly complex and various)?
- How is the employer to ensure that what is provided *complies* with the contract? Clear provision has to be made for *inspection* of the works, before they are covered up and generally throughout the project; for the *rectification* of defects, both during the works and after they are taken over. Crucially, provision needs to be made for suitable *testing* of the works, to ensure that the performance and other requirements for the structure are satisfied; and a clear procedure and timetable for *taking over* and *acceptance* of the work by the employer must be spelled out.
- Whatever the contract, the *time* or *times* at which the contractor is expected to complete must be defined. This will include the date of *commencement* of the works or services; the requirements for the *programme* (what it should show and how it is to be revised and updated); provision for *progress reports* and monitoring of progress throughout the project; the contract *completion date* for the work or sections and the *consequences of delay* beyond that date for which no extension of time is granted.
- *Price and payment*: the price and, more generally, the basis of payment of the contractor (fixed price, remeasurement or other basis) must be defined. The amount and timing of payments (on achieving milestones in a payment schedule, for example, or monthly or other periodic payments), and the procedures for applying for and obtaining payments (employer to pay on engineer's certificate, for example) have to be defined; also the remedies available to the contractor for delayed payment and his entitlement to advance payments.
- Responsibility for *damage* to the works and *injury* to persons needs to be defined, including obligations to insure; as does *intellectual property* rights and *ownership* of plant, equipment and materials used or intended for the works.

- *Environmental* and *social* matters need to be covered, such as labour protection and compliance with local anti-pollution regulations.
- The consequences of any *failure to perform* a party's obligations need to be spelled out. These include delay damages but cover other defaults. The parties' rights to *suspend the works* or *terminate the contract* in the event of default by the other (and also the availability of termination or suspension by the employer for 'convenience', or otherwise than for contractor default) need to be specified.
- *Security* for performance of the parties' obligations, including retention and performance guarantees and bonds, needs to be defined.
- The effect of '*force majeure*' or exceptional and overwhelming events preventing performance for which neither party is responsible should be defined. When can a party be *excused* performance in such an event, for how long and with what effect?
- So-called '*boilerplate*' or standard clauses need to be completed. These cover such matters as the governing law of the contract, the agreed language of the contract and the notice provisions of the contract (whether all notices need to be in writing, for example, or whether they can be given by e-mail).
- Also important are procedures for one or the other party to make a *claim* against the other, and how claims may be determined when made. How are *disputes* to be resolved; what steps, if any, need to be taken before a formal and binding process, such as court or arbitration, is resorted to?

1.7.1 FIDIC contracts

The FIDIC construction contracts cover all the above topics and do so largely under the same clause numbers. It will be helpful to see how they deal with the important areas of *programme*, *delays* and *extensions of time*.

The three main FIDIC construction forms[11] deal with these topics in largely the same way, but with notable differences when it comes to the grounds on which a contractor might obtain an extension of time.

[11] These are the 'Red', 'Yellow' and 'Silver' Books. The FIDIC contracts have short-form or nicknames, taken from the colour of their respective covers. The 'Red Book' (with its red cover) is the *Conditions of Contract for Construction (for Building and Engineering Works Designed by the Employer)*, first edition 1999. This, as we will see shortly, is the most traditional of the FIDIC forms in having the employer responsible for all or most of the design and an important role for an administering engineer. The other two main FIDIC forms, although very different in important respects, are both design-build contracts, in which the contractor takes responsibility for all or most of the design. These are the 'Yellow Book', or *Conditions of Contract for Plant and Design-Build* (*for Electrical and Mechanical Plant, and for Building and Engineering Works, Designed by the Contractor*), first edition 1999, and the 'Silver Book', the *Conditions of Contract for EPC/Turnkey Projects*, first edition 1999. See pp. 22–26 for a fuller description of these contract forms and how their main features compare and contrast. In Part Two of this Handbook we will consider these two design-build forms more systematically.

1.7.2 Programme

Clause 8 of the contracts provides that the commencement date for the works must be notified to the contractor at least seven days beforehand unless otherwise stated in the contract. After receiving the instruction the contractor must proceed without delay and must complete the whole of the works and any section within the time for completion of the works or that section (Clauses 8.1, 8.2).

The contractor must submit to the contract engineer (or, in the case of the Silver Book, the employer or his representative) a programme within 28 days after receiving the instruction to commence.

The programme is important in any construction project for at least these two reasons:

- it is the basis for monitoring the contractor's progress and planning project activities; and
- it becomes a base reference for the relevant decision-maker (engineer or employer) to determine the contractor's claims for extensions of time for completion arising from delaying events.

Broadly speaking, in FIDIC contracts the programme has to show:

- the order of execution of the works, including the anticipated timing of each major stage of the works;
- the sequencing of the works;
- the periods for review of contractor's documents;
- the sequence and timing of inspections and tests.

Whatever the specific contract, generally the programme should show that the works will be completed within the time for completion and should identify the critical path. In the FIDIC contracts, the programme should also be accompanied by a supporting report (or method statement) setting out how the contractor intends to execute the works and the resources he intends to use. This is a matter of good practice which should probably apply whatever the contract.

An important feature of FIDIC contracts is that the contractor is required to give advance notice or early warning to the engineer or employer of potential events which might adversely affect or delay the works. This requirement has a far wider application than just in relation to the programme. The purpose is to enable the contractor and engineer or employer to work together to minimise the effects of the potential delaying event. The notice gives the engineer or employer the opportunity to take action to overcome the problem before the contractor incurs delay or additional cost.

1.7.3 Delays and extensions of time

The FIDIC contracts list a number of events or circumstances which, if they delay the completion of the works, will entitle the contractor to an extension to the contract completion date. If any of these delaying events or circumstances

occurs, the contractor is entitled to an extension of the time for completion provided he claims it in accordance with the time limits and other requirements of clause 20.1.[12]

The circumstances listed in clause 8.4 of the Yellow and Red Books are:

- variations or in the Red Book other substantial changes in the quantity of an item of work;
- causes of delay giving rise to an entitlement under another sub-clause of the contract;
- exceptionally adverse climatic conditions;
- unforeseeable shortages of personnel or goods caused by epidemic or governmental actions;
- any delay, impediment or prevention caused by or attributable to the employer, the employer's personnel or the employer's other contractors on the site.

In the other main FIDIC construction form, the Silver Book, only the first, second and last of these grounds apply (variations, express mention in another clause of the contract or delays attributable to the employer). This reflects the different approach to contractor risk in the Silver Book, as we will see in some detail shortly.[13]

The FIDIC contracts enable the engineer or employer to take steps to counteract slow progress by the contractor. If he fails to maintain sufficient progress to complete the works by the completion date, or has fallen (or will fall) behind the current programme, other than by reason of one of the causes entitling him to an extension of time, then the engineer or employer can instruct the contractor to submit a revised programme and supporting report describing the revised methods he proposes to adopt, at his risk and cost, to expedite progress and complete on time.

1.7.4 Delay damages

If the contractor fails to complete within the time for completion (after taking account of any entitlement to extensions of time) then he must pay 'delay damages' to the employer. These are to be paid at a rate stated in the contract, and are meant to compensate the employer for being kept out of his plant or other facility for longer than he should have been, by reason of the contractor's default in not completing on time.

To claim the delay damages the employer must give a notice of his claim to the contractor,[14] and the engineer or employer should then make a determination or decision about the claim (unless the contractor agrees it).

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[12] See pp. 74–75 for the clause 20.1 (contractor's claims) procedure.

[13] See pp. 22–26. As we shall also see, in the Silver Book no additional time is permitted for unforeseeable physical conditions (whereas it is under clause 4.12 of the Yellow and Red Books) or, except in limited circumstances, for errors or omissions in the data or information provided by the employer.

[14] Clause 2.5; see pp. 38–39.

The rate of delay damages needs to be agreed with some care. In some legal systems, a distinction is drawn between 'liquidated damages' (an agreed daily rate to compensate the employer for the loss which is likely to result to him from delay to the works) and 'penalties'. 'Penalties' are not enforceable whereas liquidated damages are regarded as valid compensation for delay.

If the governing law of the contract draws such a distinction then an excessive rate of delay damages in the FIDIC (or other) contract may not be valid. In that event, the employer would have to prove to the satisfaction of the relevant court or arbitration tribunal what actual loss or damage he incurred as a result of the delay; something which might be both difficult to establish on the evidence and certainly time-consuming and expensive.

1.8 Tailoring the contract

Before we turn in more detail to risk, we should note one important point about drafting construction contracts using a standard form like FIDIC.

The 'normal' or standard terms in FIDIC contracts are called *general conditions*. They make up the bulk of the printed FIDIC form but, as with any contract, it will be necessary for the parties to be able to alter or amend these to suit their particular project. Whenever the parties use a standard form contract, they will need to be able to make such changes or amendments (either by deletion or addition). The construction contract should therefore provide a means by which this can be done.

In the FIDIC contracts this provision is made by use of *particular conditions*. The particular conditions:

- enable the parties to complete certain clauses in the general conditions (the 'boilerplate' clauses) by adding project-specific details, such as we have just considered (governing law; the commencement date; the ruling language; and a host of other details relevant to the specific project); and
- enable the parties to change the terms of the general conditions to reflect their particular bargain or agreements about the project.

At the back of each of the FIDIC Books guidance is provided on the preparation of particular conditions, including model wording for various different options and project needs.[15]

[15] The standard, or general, conditions cannot be directly amended in a FIDIC contract without first obtaining a licence from FIDIC to do so.