

Recording Employer's Costs following Termination for Contractor Default

This Note can usefully be read together with, and is a development of Franco Mastrandrea, “*The Quantification of Termination Claims for Contractor Default*” [2022] *The International Construction Law Review* 268.

NB Often, in the interests of speed, desire to contain likely further costs, or other reasons, replacement or continuation contracts may be let on a less risky (for the replacement contractor(s)) basis such as cost-plus or even on dayworks or “*force account*”. Such arrangements may not only be markedly more expensive than those under which the original contract was let (such as lump sum arrangements), but also may be associated with significant inefficiencies in the continuation arrangements (it will very likely be suggested by those representing the original contractor that there is no incentive on the part of either the employer or (the) continuation contractor(s) to contain those costs). The aim should be for contract terms with the continuation contractor(s) to be specifically designed to limit inefficiencies. Thus, in resolving any dispute with the original contractor, the questions whether (the) replacement contract(s) should have been let on different terms, or should have been more appropriately managed or controlled, or were executed inefficiently, may become pertinent and potentially contentious considerations. Record investigations into, and decisions made on the appropriate replacement arrangements (and perceived justifications therefore).

1. The common law compensatory damages principle (and usually express contract termination provisions in common use) seeks to place an innocent employer who has terminated an original contractor's employment for cause in the position that the employer would have been in had the original contractor, contrary to fact, performed the contract according to its terms. Where the original contractor's performance has been terminated for cause there will typically be a final reckoning/ statement of accounts between the original contractor and the employer. This (usually deferred until after the outstanding works have been completed), typically involves a comparison between the actual costs/losses incurred by the employer and what the employer would have paid had the original contractor taken the works to completion.
2. The sum against which the legitimate actual costs are to be compared, on the credit side of the equation for the original contractor, is the total amount which would (otherwise) have been payable (on due completion by the original contractor) for the works in accordance with the contract, typically labelled a “*notional account*”.

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3. Given that what will be involved will largely be costs-based claims, there will need to be answers to (and the costs system will need to be set up to meet the challenge of answering) the following questions: see upcoming article - Franco Mastrandrea, *Localised delays - the poor relation in construction claims appraisals?*, 2023 ICLR 112:
- a. Has the claimant (here the employer) incurred the sums that it claims?¹
 - b. To what extent are the sums claimed attributable to the matters relied on by the claimant (here the employer)?²
 - c. Are the costs claimed reasonable?³

¹Providing an adequate answer to this question involves enquiries of matters such as: whether the sums claimed are traceable to and through the various stages of the employer's cost and accounting system; the extent to which the employer has paid its contractor(s) the sums(s) that it claims; whether the sums claimed include estimates, forecasts, adjustments (such as for on-costs, consumables, etc.) and if so, the extent to which they are appropriate and reasonable; and the extent to which account has been taken of credits, transfers, discounts, rebates, accommodations, contra-charges etc. which affect the value of the sums claimed.

The verification of costs incurred requires appropriate access to documents which identify the total costs of the project including management accounts, statutory accounts, and the job costing system, the method of cost allocation, and the definitions of cost and the cost codes used sufficient to allow objective checking of costs claimed through that system from the lowest source documents to the apex organisation accounts and to track the allocation and costs of all resources into it from relevant records – including the rationale for and decisions made on procurement strategy; invitations to tender; tenders; reason for decisions to appoint; orders/contracts; invoices; payment vouchers/certificates, payments (including bank statements, etc.) ledgers; final accounts; time sheets, wage sheets, payroll, fringe benefits, other on-costs; establishment charges; information about the commercial arrangements for the supply of plant and equipment, including purchase amounts, ages, writing down policy, rental agreements; copies of claims/counterclaims/contra charges made by or against the employer which may have a bearing on the value of the claims made; correspondence/dealings/final accounts and records of payments to and from organisations whose financial claims are pursued by the employer or who have made claims against the employer which alternatively explain the financial claims; documents evidencing any relevant settlements and payments made which explain the parties' contentions and the settlements reached and why; audited accounts demonstrating actual overheads, and details (if any) of alternatives alleged to have been lost; in respect of interest/financing charges details of costs incurred or opportunities lost as a result of the complaints relied upon; details and records of currency exchange losses alleged to have been incurred.

The difficulty with an approach which falls short of this is that because it is not open book, it may be incomplete and may as a result be misleading.

² An adequate answer to this question is likely to involve the following more detailed enquiries (and documents should record): whether the sums claimed have been correctly allocated to the project and to the default relied on; the nature of the sums claimed such as one-off, time-sensitive, volume-related etc.; enquiries into the reasons and events which it is alleged gave rise to the sums claimed; whether the sums claimed would have been incurred in any event, and if so whether loss of alternatives foregone have been shown; what other reasons or events may explain incurrence of the amounts claimed.

Forming a view as to whether the sums claimed are properly attributable to the matters relied on may involve consideration of relevant tender build-ups where the claims for actual or additional cost rely on the adequacy of counterpart allowances in that tender; for personnel their disciplines, grades, tasks, time records, allocation, and quantities of work carried out; for plant and/or equipment: time and allocation records showing down time, the cost of repairs and maintenance, and quantities of work carried out; correspondence/dealings/final accounts and records of payments to and from organisations whose financial claims are pursued by the employer or who have made claims against the employer which alternatively explain the financial claims; internal reconciliation statements or reports which address or have a bearing on those claims; copies of claims/counterclaims/contra charges which address or have a bearing on those claims.

These questions should generate a process of enquiry which includes the location and ordering of relevant information, and the checking, processing, and analysis of that information.

It would in the ordinary course be incumbent upon the employer not only for reasons of sound and robust contractual administration internally but also to satisfy objective requirements of the satisfactory proof and substantiation of claims, that it have in place a system which not only located with sufficient certainty the true additional costs generated by the issues about which complaint is made, but also tracked those costs appropriately and comprehensively as its response to the alleged difficulties were implemented.

Thus, a properly designed response should ensure that relevant tasks and costs which were truly additional to the original contractual obligations were identified, managed and audited. This should be capable of identifying and separating out matters attributable to other causes, such as poor original estimating, and the poor performance (by either the employer or any of its contractors) of either those original contractual obligations or of the newly commissioned obligations. Contracts routinely let on a labour supply basis rather than on a task or results related arrangement, increase the need for careful control to ensure that the deployment and use of resources was efficient. It would be expected in those circumstances to see a full description of the processes introduced by the employer and/or its relevant contractor to ensure that the resources were necessary, appropriate for the work in hand, and deployed efficiently. In this context a related consideration is the terms upon which such contracts are let, or varied.

³ Whether costs incurred are reasonable involves a number of more detailed enquiries, such as whether the procurement process was appropriate for the works procured having regard to the circumstances prevailing when it was carried out; whether contract terms entered into were reasonable having regard to the sums claimed, the terms of any head contract and the circumstances prevailing when any associated sub-contracts were made, varied or settled; whether the amount claimed has been properly and reasonably incurred having particular regard to the avoidance of waste, adequacy of supervision, control, etc.; whether expenditure which could reasonably have been avoided has been paid; whether there is any duplication; whether the employer has calculated and paid the sums that it claims in accordance with the appropriate terms of the sub-contract or supply contract.

4. An essential feature of these costs is that they are properly recorded and are easily and comprehensively accessed.
5. Are there any third party rights that might be exercised (such as funders' rights to step in)?
6. Are there any rights that the employer may want to assign, such as the original contractor's contracts with third parties?
7. Costs for securing possession of the site. Code for and record documents and costs of investigating, procurement, administering and close out.
8. Costs for protecting the executed works against damage. Code for and record documents and costs investigating, procurement, administering and close out.
9. Make the site, partly completed works, and materials, safe. Code for and record documents and costs of investigating, procurement, administering and close out.
10. Consider whether performance or other bonds/securities provided in relation to the original contract should be called or invoked; administer their call, encashment and their proper accounting and close out. Code for and record documents and costs of investigating, administering and close out.
11. Consider the costs of repatriation/disposal of the original contractor's resources having regard to the original contract terms. Code for and record documents and costs of investigating, administering and close out.
12. Has the Employer to take out additional insurance of the works and materials? Code for and record documents and costs of investigating, procurement, administering and close out.
13. Undertake a proper and more complete appraisal of work progress on site than would have been available through the standard contract administration/interim payment system: who, when, and at what cost? Code for and record documents and costs of investigating, procurement, administering and close out.
14. Arrange for the continuation of temporary support work and common user plant such as scaffolding. Code for and record documents and costs of investigating, procurement, administering and close out.
15. Identify defective work, and provide for its removal and replacement. Code for and record documents and costs of investigating, procurement, administering and close out.
16. Identify and check the quality and availability of materials and goods on and off site which have become the property of the employer. Code for and record documents and costs of investigating, procurement, administering and close out.
17. Identify and specify a scope of works for the continuation contractor(s) sufficient to act as a sound basis for the administration and close out of the remaining works, including the identification of long lead items. Code for and record documents and costs of investigating, procurement, administering and close out.

Part of the relevant context for the analysis involves a consideration of the responses of the employer to those claims at the relevant time, and in particular its appraisal of the situation at that time, being a relevant feature in determining whether the costs incurred in consequence were reasonable.

At the organisational level useful indicators of this would be management accounts and internal reconciliation statements.

At the project level what is relevant is how the re-procurement process was used and in particular whether it was used appropriately, involving a consideration of the tendering procedures and appraisals, and contracting methods used by the employer. Clearly the prevailing circumstances may introduce the need for greater urgency than would apply to a project which was unfolding in broadly the expected manner, and thus render of marginally less concern the pursuit of procurement strategies which achieve greatest cost certainty. It will assist if this is articulated and recorded.

But precisely because in such circumstances costs are likely to escalate unreasonably, the employer is best advised to pursue a robust, well-structured, and effective policy to promote economy in not only the original re-commissioning of that work, but also in its variation from time to time and its commercial settlement. Thus even if work was procured on a time and materials basis, and it was appropriately so procured, the employer should nevertheless pursue (and articulate and record the actions directed at) the objective of delivering the now impacted project:

(a) As economically as possible;

(b) By not engaging greater resources than were in the circumstances reasonably required; and

(c) By reference to a proper definition of what items are recoverable and the financial basis upon which that recovery is based.

Something which did not satisfy these criteria would run the risk of being little more than open-ended obligations.

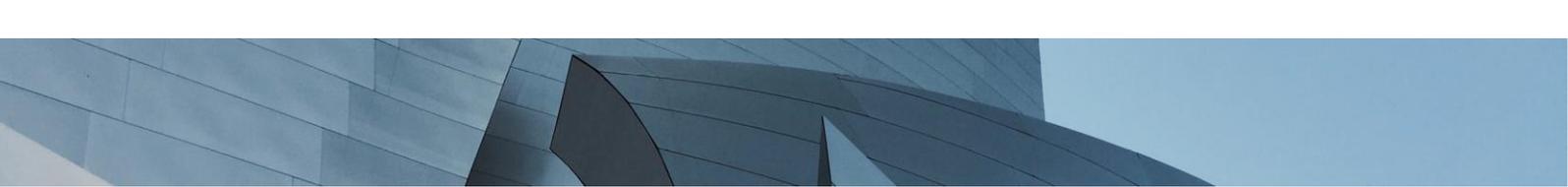
Managing the process so as to keep within reasonable parameters after procurement is another key concern.

18. Devise, draw up and administer tendering procedures/pricing documents for (a) replacement contractor(s) including the potential need to novate supply and subcontracts to the replacement contractor(s). Code for and record documents and costs for devising, drawing up and administering procurement, administering and close out.
19. Canvass potential continuation or replacement contractors. Code, procure, administer and close out;
20. New replacement contracts. Code for and record documents and costs of investigating, procurement, administering and close out. Identify variations and their costs; to the extent that these may have been variations under the original contract identify the extra over/reduced costs that are involved for the purposes of (a) notional account(s) (see 2 above). Ditto with claims arising under the replacement contracts (e.g. escalation, prolongation, disruption).
21. Costs of consultants. Code for and record documents and costs of investigating, procurement, administering and close out. Identify variations and their costs; to the extent that these may have been variations under the original contract identify the extra over/reduced costs that are involved for the purposes of (a) notional account(s) (see 2 above). Ditto with claims arising under the replacement contracts (e.g. escalation, prolongation, disruption).
22. Costs of in house personnel/facilities. Code for and record documents and costs of investigating, procurement, administering and close out. Identify variations and their costs; to the extent that these may have been variations under the original contract identify the extra over/reduced costs that are involved for the purposes of (a) notional account(s) (see 2 above). Ditto with claims arising under the replacement contracts (e.g. escalation, prolongation, disruption).
23. Other in-house costs. Code for and record documents and costs of investigating, procurement, administering and close out. Identify variations and their costs; to the extent that these may have been variations under the original contract identify the extra over/reduced costs that are involved for the purposes of (a) notional account(s) (see 2 above). Ditto with claims arising under the replacement contracts (e.g. escalation, prolongation, disruption).
24. Overheads. Define, code for and record documents and costs.
25. Identify variations and their costs; to the extent that these may have been variations under the original contract identify the extra over/reduced costs that are involved for the purposes of (a) notional account(s) (see 2 above). Ditto with claims arising under the replacement contracts (e.g. escalation, prolongation, disruption).
26. Delays: extant at date of termination, and in getting re-started; agreeing a viable completion programme and executing the completion works. Evaluate, determine actions and perceived justifications therefor and monitor and close out, recording all.
27. Closing out all accounts, including settling claims. Note that it will be important to show that the costs are reasonable, which will include operating accounts in accordance with the relevant continuation contracts (see 3.c above).
28. Are there likely to issues over liquidated damages and if so, is there an easy split between those accrued at the date of termination, which will require an appraisal on delay caused as at that date, and post-termination LADs? Evaluate, determine actions and perceived justifications therefor and monitor and close out, recording all.

Contact details



Dr Franco Mastrandrea
Partner
 francomastrandrea@hka.com
 T: +44 (0) 7884 436 537



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