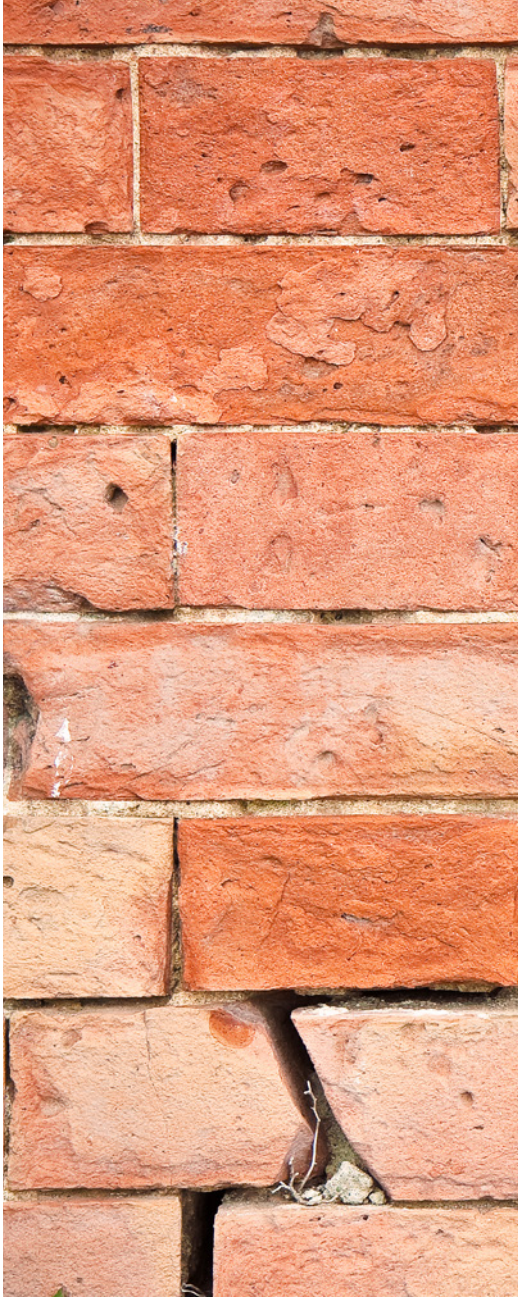
UPDATE
CONSTRUCTION LAW

Crisis? What Crisis?

Time for structural reform in the construction industry

BY **JOHN WALTON**



MBIE's Sixth National Construction Pipeline Report for 2018 sets out the most recent national projection of building and construction activity for the next six years. The report predicts sustained growth, with 43,000 national dwelling consents in 2023, and $41 billion spending across all forms of construction (residential, non-residential and infrastructure).

The market for new housing and the commitment to infrastructure development on any estimation continues to be buoyant, and yet construction contractors continue to fail. How can this be?

The problem is endemic with failures matching surges in construction spending (Hartners in 2002, Mainzeal in 2013 and Ebert this year to name the most significant). Similarly, the country's largest construction company, Fletcher Construction, with a market capitalisation of $5.8 billion, posted a $190 million loss for the 30 June 2018 year.

Hardly a day passes without the press reporting the latest pet solution, whether it is blaming lawyers for drafting extensive and complex special conditions or a lack of protection of subcontractors. The latest proposal is for the Government to fund training apprentices. Each of these solutions, while commendable, addresses symptoms rather than dealing with root causes.

A case in point was the introduction of the statutory trust regime for retentions in the 2015 amendments to the Construction Contracts Act 2002. The justification for this change was the failure of Mainzeal Property & Construction in early 2013; yet the liquidators have recently disclosed that far more is owing to unsecured creditors than the $157 million claimed to date. The protection of retentions is misguided; in the case of Mainzeal, there was a $7 million shortfall between what Mainzeal was owed under its head contracts ($11 million) and what it had retained from subcontractors ($18 million). While $7 million is a significant sum, boosting retentions by such an inflated sum is reprehensible, protecting $18 million when over $150 million is owing is little short of fiddling while Rome burns.

Any analysis must start with a recognition that material costs are inexplicably high, skilled labour in short supply and contractor margins unsustainably low. Add to that a highly competitive market, and we have fertile ground for contractor failure. This is nothing new. The UK recognised the problem in 1994, with the Latham Report, *Constructing the Team*, describing the industry as "dysfunctional"; in Australia, the Blake Waldron survey of *Pressure Points in Australian Construction and Infrastructure Projects*, reached similar conclusions in 2005; and this year in New Zealand, Russell McVeagh's *Survey of Construction Disputes*, found that 70% of industry participants expect construction disputes to increase over the next two years.

This is not very encouraging reading.

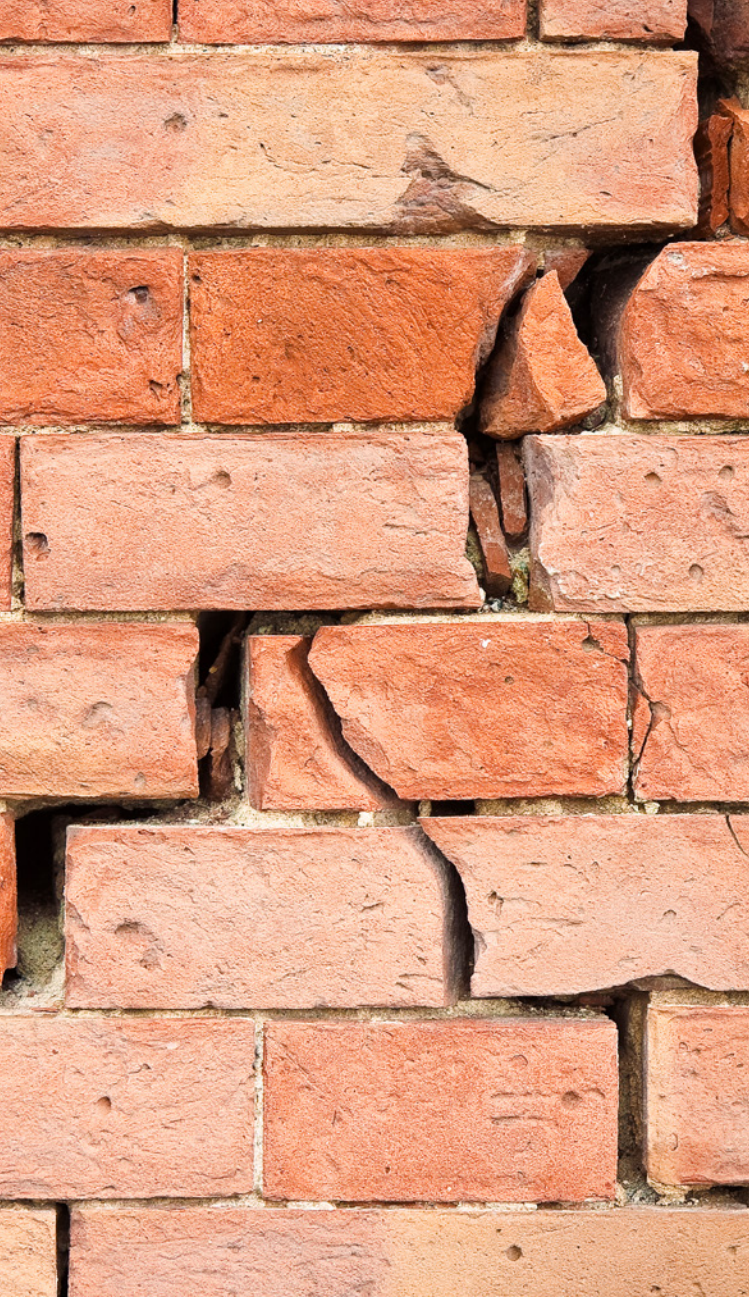
The starting point

Any solution must start with a recognition of the roles of the parties. A successful project results in the owner receiving a completed project which meets its expectations as to price, performance and time of delivery; and the contractor and all subcontractors having their costs covered and making a reasonable profit for their efforts.

For its part, the owner typically supplies the site, or access to it, resource consents, designs and pays for the cost of the work. Obviously, there are exceptions to this, but in general terms, the owner defines the work, organises finance for it and procures the rights for the contractor to carry out the work. Any departures from these fundamental obligations involves the transfer of risk which complicates the procurement process and potentially puts the project at risk.

For its part, the contractor prepares a construction methodology, drafts a programme for the works and arranges labour, procures goods and materials, and prices the work based on the information provided by the owner.

Central to this division of responsibility is recognition that it is the owner's project; and the contractor is simply constructing the permanent work (whether a house, a commercial building or essential infrastructure) to the owner's requirements. Typically, the owner has limited interest in how and in what order the contractor



carries out the work and the contractor similarly has limited interest in the end product, beyond achieving the quality required for the price quoted.

Things become complicated when owners understandably want price, quality and time certainty at a time when the design is incomplete and there is considerable uncertainty over critical issues like ground conditions, weather, economic changes (the recent increase in fuel prices is a case in point), supply chain management and scope changes by the owner. The majority of construction disputes turn on a mismatch between what the contractor tendered to construct and what the owner subsequently instructed as variations.

While such uncertainty creates fertile ground for disputes, the seeds for dispute are sown with the traditional competitive procurement process and the irresistible opportunity for owners to transfer risk that the tender process provides. As lawyers, while we are motivated to do the best for our clients, this rarely results in best for project outcomes. The statistics speak for themselves.

Flaws in the tender process

This is unlikely to change for so long as contractors are required to tender fixed prices on incomplete designs and to take the risk for uncertain events which may impact on buildability, price and time for delivery. The tender process forces contractors to be aggressive in their pricing, and it is rarely recognised that preparing tenders is an expensive and time-consuming process. Each failed tender has an immediate adverse impact on the contractor's overhead. Yet, if the contractor takes an aggressive or optimistic view to tendering, while it may be successful, it then comes under pressure to protect what little margin it has left, and to claim additional payment and time under the contract at any opportunity.

Our putative contractor may also have been forced to accept uncertain risks during the tender process which cannot realistically be avoided or mitigated. Granted, the contractor may have allocated a contingency to cover such risks, but that will be guesswork at best. From a project perspective, such risks may or may not eventuate, and if they do there is no guarantee that the contingency will cover the cost; it is highly likely that the contractor will claim in any event.

It should be clear that, while the traditional competitive tender process might appear to be good practice, the reality is that all too often achieving a successful project is little more than a lottery. It is inevitable that a tender based on incomplete design will result in claims for further payment, and that owners will resist making such payment.

Regrettably, the Government is the largest participant in the construction sector and has been the biggest culprit. Unreasonable and, frankly counter-productive, allocations of risk have been the hallmark of government procurement over the last few years. While the *Government Rules of Sourcing* promote value for money on a whole of life basis, it also mandates competitive procurement processes.

Further, when Government projects have shown the potential

to overrun budgeted costs, the solution has been to replace the project management team with those that adopt a more rigorous and muscular approach. For contractors, this has meant running the risk of embarking on an expensive and uncertain disputes process, and damaging the potential for future Government work, or taking the loss on the chin in the hope that those losses can be recovered at a later date.

In the worst cases, contractors will pass on risks to subcontractors or they will use their cashflow from other projects to cover losses in the hope that it will all work out in the end. The reality is that this game catches up with the contractors in the end, with a significant impact not just on the contractor, but on the whole supply chain; and inevitably on the owner, with its incomplete project. There is no shortage of contractors with full order books and cranes all over the city skyline who had no idea they were trading insolvent (Hartners was a case in point).

Four steps to a solution

The problem, while complex, is far from insurmountable.

First, both owners and contractors should work together to reduce uncertainty before prices are fixed. Typically called *early contractor involvement*, the approach is for the contractor to identify constructability issues during the design stage, and for further investigations to be carried out, for example in relation to ground conditions, to reduce uncertainty. This is also an opportunity for designers to provide more than a 30% design, which is typically given at the tender stage.

Second, adopt an appropriate allocation of risk for the project. Risk is generally project specific, and should be identified and continually monitored during construction. This is less an issue of risk ownership, than the early identification of risks to the project and measures which can be taken to avoid or mitigate those risks. Typically, if a risk does not arise from something within the contractor's control it should be compensated for.

Third, the form of contract for the project should be appropriate for the project and the allocation of risk. Successful projects have contracts which reflect the requirements of the project, rather than forcing the project into the form of contract. This may mean that special conditions need to be prepared; provided they are drafted sensibly with an understanding of project risks, they need not be a cause for concern.

Fourth, there needs to be greater recognition that subcontractors effectively carry out the majority of the work in any construction project. It is not sufficient for owners to simply pay head contractors, and say "not my problem" when subcontractors point out that they haven't been paid. One easy solution to this is to amend the Construction Contracts Act to make owners additionally liable for any amounts found to be owing by head contractors to subcontractors. The Act already has a similar procedure where the construction site is owned by an "associate" of the contracting owner.

This may be controversial, but it is not dissimilar to the old Wages Protection and Contractors' Liens Act 1939 (repealed in 1987). The practical impact for owners and financiers is that they will take more care to ensure that project cashflow is properly making its way down the contract chain. It is, after all, the subcontractors who carry out the majority of the work; and if there is a genuine problem with performance by a subcontractor which justifies withholding part of a progress payment, it is not unreasonable for the owner to know, and for the owner to hold the amount deducted.

Finally, the sooner any potential for disagreement is identified the better.

Regrettably, the multi-tiered dispute resolution clauses favoured by lawyers since the Channel Tunnel project* have done little but entrench the parties' legal positions, rather than seek workable solutions on a best for project basis. While, in the past, the engineer has fulfilled the role of interim, impartial disputes resolver, projects have become more complex and conflicts of interest harder to ignore.

The most effective solution is to provide for early, acceptable, interim binding decisions either as a result of adjudication under the Construction Contracts Act or, for larger projects, the establishment of a sitting disputes board.

Responsibility for the current state of the construction industry undoubtedly rests with owners and their advisors. The solution to the problem rests on both owners and advisors to be brave enough to embrace the solution, rather than continue with a business as usual approach in the hope that it will all work itself out in the end; or that they will be lucky. ■

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**The Channel Tunnel project was globally significant in the construction industry for two reasons – (1) it adopted a multi-tiered dispute resolution procedure, under which a party could not go to arbitration without first completing the preliminary stages, and (2) the House of Lords held that preconditioning access to arbitration, or to court for that matter, did not adversely impact on access to justice.*

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