

# MASONS THELEN REID LLP

## OCAI Construction Seminar

### MANAGING NOMINATED SUBCONTRACTING ON INTERNATIONAL CONSTRUCTION PROJECTS



Global Infrastructure Lawyers<sup>SM</sup>

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# Nominated Subcontracting

## Plan

- **What is it?**
  - FIDIC Conditions of Contract for Works Civil Engineering Construction, Fourth Edition, 1987 (*'Red Book 4<sup>th</sup>'*)
  - The Singapore Institute of Architects Articles and Conditions of Contract Standard provisions (*'SIACC'*)
- **What is it not?**
- **Why nominate?**



# Nominated Subcontracting

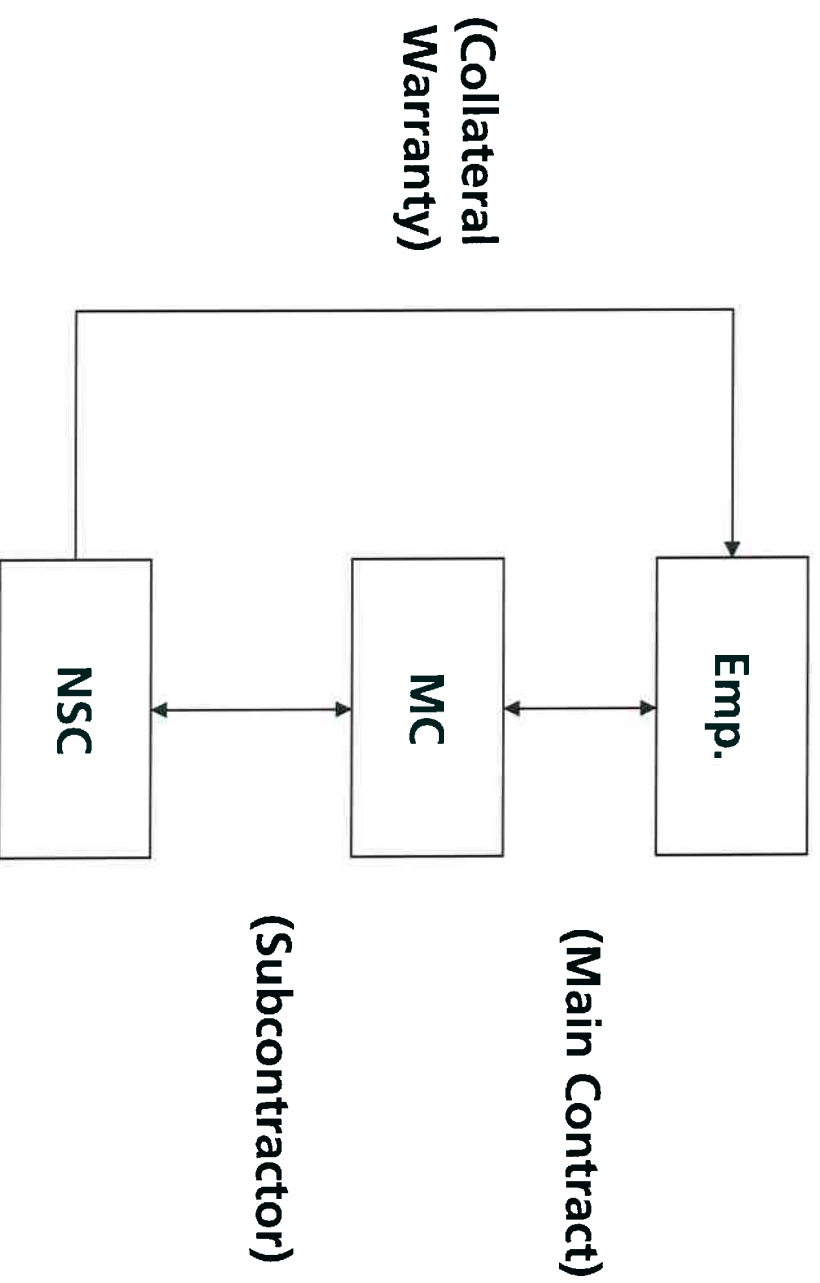
- Key commercial issues
  - Selection Procedures
  - Defects in Works and/or materials
  - Delay or Disruption to the Works
  - Insolvency
- Problems with the Red Books and SIACC
- Possible solutions to those problems

# What is it?

- Nomination is the process by which the Employer ('Emp.') nominates selects or approves who will perform a subcontract or specialist trade role ('NSC') who then enter into subcontractors with the Main Contractor ('MC'). It is a means for Emp to retain some control over the selection of specialist contractor or supplier without necessarily becoming directly involved in detailed contractual arrangements.



# What is it?



# What is it not?

## Domestic Subcontracting

A '*domestic subcontractor*', is one in whose selection and appointment the Emp. traditionally plays no part, other than simply giving consent where this is required under the terms of the main contract. The appointment of the subcontractor is treated as being something entirely for the benefit of MC – a purely '*domestic matter*'.

Although MC delegates performance of a part of the works to his domestic subcontract, MC nonetheless remains fully responsible to Emp. with respect to these works. Emp. in no way underwrites the risk of subcontractor default. MC is also directly responsible to the domestic subcontractor for payment and for their fundamental co-operation.

# Why nominate?

Nomination is used because there are benefits for Emp. in using the system. The key benefit for Emp. is control over the choice of, and performance required from, NSC. Above all, Emp. reserves to itself the choice of subcontractor.

NSC may offer the lowest bid or highest quality design input, or some combination of price and quality benefits. NSC may have a proven track record for good work. Emp. may have developed a long term business relationship with NSC. Emp. may wish to use a proprietary system offered by NSC.

# Why nominate?

Further, Emp. can, if he wishes, control the terms of the subcontract, including the price and scope of NSC's works.

Another benefit is the potential for reduced procurement times. Some specialist subcontract work requires a longer lead time than the construction programme would allow, therefore, such work must be started before MC has been chosen. Nomination allows for continuity where a specialist subcontractor has been selected before MC is in place.



# Key commercial issues

- Insufficient description of NSC Works
- Selection problems
- Defects in Works and/or Materials
- Delay or disruption to the Works
- Insolvency

# NSC selection procedures

# Red Book 4<sup>th</sup>

A person executing work or supplying goods may be a NSC if the work or supply is the subject of a Provisional Sum, or if they are 'nominated' or 'selected' or 'approved' by the Emp. or the Engineer.

This means such a person can be a NSC if they are identified in an 'agreed' list of proposed subcontractors.

The *World Bank Standard Conditions of Particulars Application* state that where the Emp. supplies plant for use in the Works, he can be 'treated as' a NSC. This approach is not conceptually straightforward however.

# Red Book 4th

FIDIC recognises that the failure of NSC to perform can have serious consequences for both MC and Emp and, therefore, it is important to ensure that MC approves of the subcontractor, and is prepared to collaborate with him. Thus MC need not employ just any NSC. He need not employ anyone:

- against whom he has reasonable objection, OR
- who refuses to enter into a subcontract which:
  - is back-to-back with the main contract; AND
  - which indemnifies MCs in respect of NSC's breaches and against the negligence of his workmen and misuse of any Temporary Works.

# Red Book 4th

These rights of veto are crucial and Japanese contractors generally must not feel reluctant to exercise those rights.

Thus, MC can refuse the nomination if he has reasonable grounds for so doing. What is '*reasonable*' must take account of the importance of the timing of the nomination, the affect a post-contract nomination may have in MC's programme, and NSC's preparedness to commit to completion of the nominated subcontract works on a date that melds with the programme.

## Red Book 4<sup>th</sup>

Where however NSC has been appointed in advance of the Contract date, the right to object may be more limited, provided that appointment was notified to MC beforehand and no objection was made or highlighted as a likely reaction to formal nomination.

If MC decides not to enter into a subcontract with NSC, the Engineer will have three alternative lines of action open to him. He can:

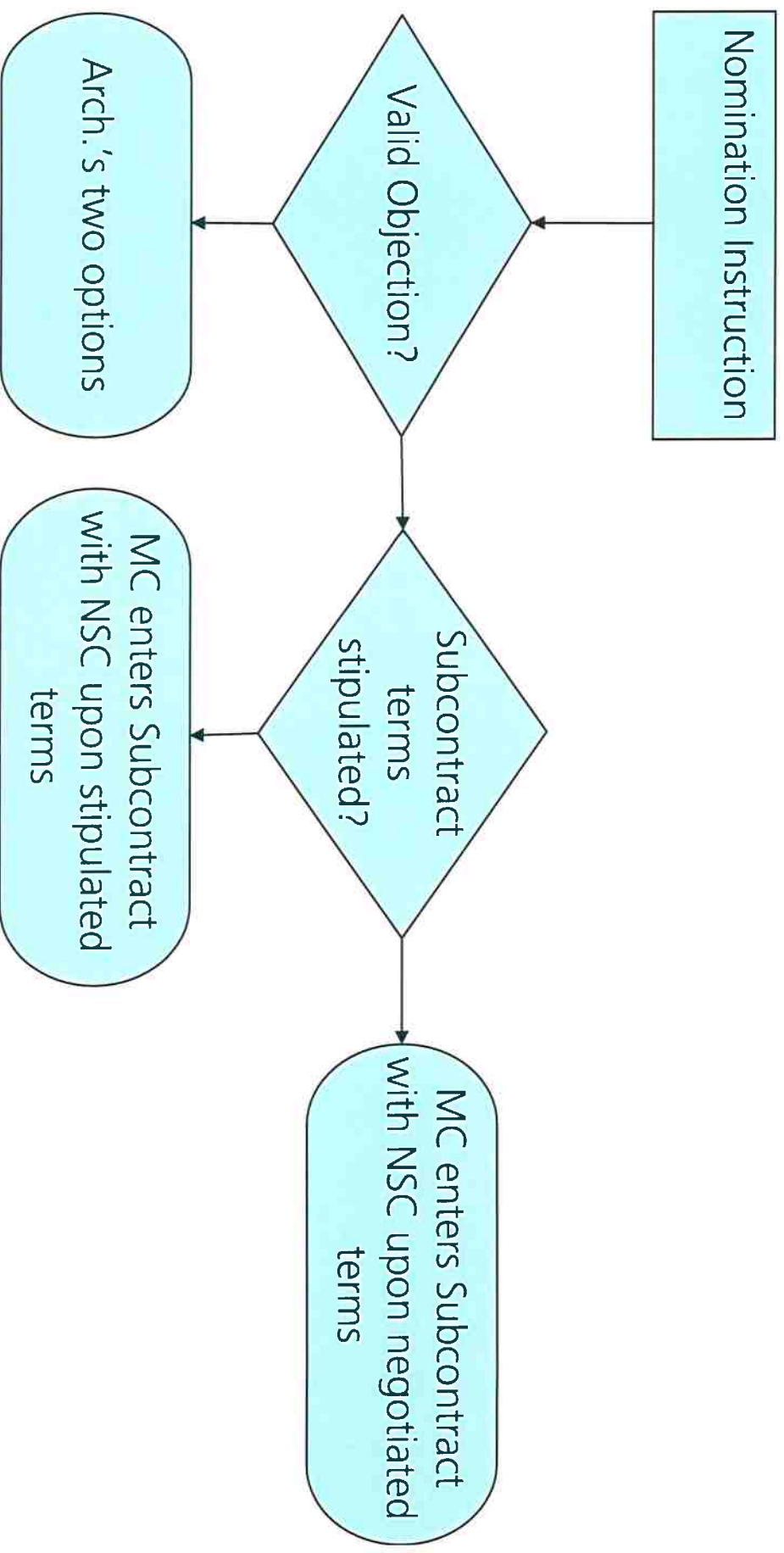
- Nominate an alternative NSC to whom MC would not object.
- Omit the work which in the subject of the nomination from the main contract and have it carried out by an independent Contractor - this can have claim consequences.

# Red Book 4<sup>th</sup>

- Seek to negotiate with NSC more favourable terms of the subcontract
- Subject to MC's consent, indemnify MC against any liability he might suffer from contracting with NSC on the terms NSC will accept.
- Direct MC to carry out the work, or arrange for the supply of the goods, himself through a variation under Clause 51 – this also can have claim consequences

# SIACC

## Nomination & objection process





# SIACC

The position under SIACC is very similar to the Red Book approach. The Emp. may:

- where the identity of the subcontractor is known at the time of tender, designate a subcontractor in the Specification or other Contract Documents – '*Designated Sub-contract*' ('DSC')
- select a subcontractor to carry out work for which a reference to a Prime Cost, Prime Cost Sum, Prime Cost Item, Provisional, Provisional Sum, Provisional Sum Item, '*Contingency*', '*Contingent*', '*Contingency Item*' or '*Contingency Sum*' is used in the Specification or other Contract Documents ('NSC')

# SIACC

Note, DSC basically differs from a NSC with regard to the payment provisions and objection. Importantly, there are more limited rights of objection by MC with regard to a DSC then with regard to a NSC

There are four grounds for reasonably objection, namely:

- Reasonable grounds for supposing, on the available known facts at the time of the Nominated Instruction, NSC (but not applicable to a DSC) has inadequate:

# SIACC

- financial standing
  - solvency
  - technical competence
  - reliability
- NSC/DSC is not prepared to:
    - accept equivalent responsibilities or obligations consistent with those undertaken by MC; OR

# SIACC

- indemnify MC against liabilities, claims and damages arising from defaults of NSC in the same terms as MC's indemnity to Emp.; OR
- accept liability for reasonable delay damages; OR
- accept 14-day '*pay-when-paid*' payment terms, subject to retention and set-off or counterclaim

# SIACC

- NSC is not prepared to accept provisions in the Subcontract allowing NSC-default termination for:
  - failure to proceed with due diligence
  - failure to remove or replace work, materials or goods; OR
- NSC is imposing an unreasonable exclusion of liability having regard to MC's obligations under the main contract.

# SIACC

## Architect's powers

- Where MC raises a valid objection to NSC the Arch. may:
  - Make a further nomination; OR
  - Instruct MC to carry out or make arrangements for carrying out the work – claims may result; OR
  - Instruct MC to enter into the subcontract and then guarantee MC against any loss, damage, claim or expense incurred by MC as a direct result of matters validly objected to by him (i.e. standing, solvency, competent and/or reliability)

# Red Book 4<sup>th</sup> & SIACC

## Standard problems

If MC does not secure suitable amendment of the provisions of the Red Book 4<sup>th</sup> or SIACC, he may be faced with insufficient description of NSC Works, other than perhaps the inclusion of a provisional sum in the Bill of Materials. The true nature of the NSC Works, and its effect on programming is often only made apparent once the nomination occurs, which may be late on in MC's own works, and certainly after the terms of the main contract have been settled.

Further, MC may not have a fair opportunity to consider his power of objection to the nomination and/or to make constructive suggestions with regard to an alternative proposal.

# Red Book 4<sup>th</sup> & SIACC

## Standard problems

The solution to the first problem may involve tailored main contract amendments to the standard form conditions. The solution to the second problem involves Japanese contractors asking the right questions during the tender phase.

Where NSC will be placed after MC is selected then subclause 59.2 provides the necessary veto right. Where, however, NSC will be in place prior to the main contract tender process, a prudent tenderer will seek full details of NSC and of the subcontract terms and conditions.

With this information the prudent MC can be considering his attitude to the nomination when there is still room to manoeuvre



# Red Book 4<sup>th</sup>

## Possible solutions

### 58.2 Use of Provisional Sums

*In respect of every Provisional Sum the Engineer shall have authority to issue instructions for the execution of work or for the supply of goods, materials, Plant or services by:*

- a) the Contractor, in which case the Contractor shall be entitled to an amount equal to the value thereof determined in accordance with Clause 52,*
- b) a nominated Subcontractor, as hereinafter defined, in which case the sum to be paid to the Contractor therefore shall be determined and paid in accordance with sub clause 59.4.*

# Red Book 4<sup>th</sup>

## Possible solutions

### 58.2A

If the Contractor suffers delay and/or incurs costs by reason of the issue of an instruction pursuant to subclause 58.2 in circumstances where the work, goods, materials, plant or services, and/or the timing of the said instruction for the execution or supply thereof (as the case may be) were, in the reasonable opinion of the Engineer, not foreseeable by an experienced contract, the Engineer shall after due consultation with the Employer and the Contractor determine:

- (a) any extension of time to which the Contractor is entitled under Clause 44, and
- (b) the amount of such costs, which shall be added to the Contract Price, and shall notify the Contractor accordingly, with a copy to the Employer.

# SIACC

## 23 Extension of Time Grounds

The Contract Period and the Date for Completion may be extended and re-calculated, subject to compliance by the Contractor with the requirements of the next following subclause, by such further periods of time and until such further dates as may reasonably reflect any delay in completion which, notwithstanding due diligence and the taking of all reasonable steps by the Contractor to avoid or reduce the same, has been caused by:

...

- (h) Architect's instructions under clause 28 of the Conditions in regard to Contingency Sums (including, without limitation, in circumstances where the works, materials, goods and/or the timing of the instruction under Clause 28 of the Conditions for the carrying out or supply thereof (as the case may be) were, in the reasonable opinion of the Architect, not foreseeable by an experienced contractor).



# Defects in Works and/or Materials

# Red Book 4<sup>th</sup>

MC is responsible for the acts, defaults and neglects of any Subcontractor as fully as if they were the acts, defaults or neglects of MC. One possible exception to this is with regard to the design of any materials supplied by NSC, however this is unclear.

The subcontract must however specify that, where NSC is providing design or specification of any part of the Permanent Works or of any Plant to be incorporated therein, he will save harmless and indemnify MC in connection with any failure to perform such obligations or to fulfil such liabilities.

# SIACC

MC again is fully responsible for all NSCs and for any default and breach of contract by them in the same way as for his own work or those of other subcontractors selected or engaged by MC. On the other hand, Emp. will never be liable to MC for the default of any DSC or NSC.

As if the risk allocation was not clear enough, MC is also deemed to have accepted, as his own responsibilities under the main contract, all the obligations undertaken by NSC in his subcontract, including, as to the design, suitability, quality or performance of his work or materials or goods, or in regard to the provision of design services.

# SIACC

In cases where Emp. actually and reasonably relies upon the skill and judgment of DSC/NSC for the design or suitability of his work or materials, Emp. is regarded as having relied upon the skill and judgment of MC.

# Standard problems

If MC does not secure suitable amendment of these provisions then the problems MC will encounter are:

- With the possible exception of the fitness an/or quality of materials used by NSC under the Red Book, NSC is still a subcontractor of MC for whom MC is responsible to Emp.
- Whilst under the Red Book 4<sup>th</sup> there may be the protection of NSC's indemnity with regard to design and specification of Permanent Works, in practice, any prudent MC will still need to regard the presence of a design element in a nominated subcontractor with great caution.



# Possible solutions

In reality the solution most likely to gain acceptance does not involve amendments to main contract conditions. Instead, in line with the principles of objection under both Red Book 4<sup>th</sup> and SIACC, the solution lies in subcontract drafting and reasonable objection.

In this regard, the common use of the ICE form of subcontract without amendment is at least hazardous. Japanese contractors should be looking for their subcontracts with NSCs to include provisions for:

- equivalent responsibilities or obligations consistent with those undertaken by MC.
- Indemnities against liabilities, claims and damages arising from defaults of NSC in the same terms as MC's indemnity to Emp.
- PI insurance capped no lower than the potential liability of MC arising from design fault.
- Bonds in stipulated form

# Subcontracts

## Possible solutions

- [●].1 *On or before the date of this Subcontract, the Contractor has made available for inspection by the Subcontractor copies of the Main Contract (excluding commercially sensitive information). The Subcontractor is deemed to have studied the Main Contract and to be fully aware of the obligations and potential liabilities of the Contractor thereunder. Without derogating from the generality of the foregoing, the Subcontractor is deemed to be fully aware of the adverse financial and other consequences for the Contractor which could arise under the Main Contract in consequence, in whole or in part, of a breach on the part of the Subcontractor of its obligations under this Subcontract (and, in particular, but without limitation, as a consequence of the Subcontract Works failing to be completed in accordance with the requirements of the Main Contract).*

# Subcontracts

## Possible solutions

[●].2 *The Subcontract shall assume and properly perform, as part of his obligations under this Subcontract, the Contractor's obligations under the Main Contract in connection with the carrying out and completion of the Subcontract Works and so as to enable the Contractor to fully discharge his obligations under the Main Contract insofar as they relate to the Subcontract Works and so as not to cause to contribute to a breach by the Contractor of the Main Contract.*

# Possible Solutions

[●].3 *The Subcontractor shall indemnify the Contractor against:*

- (a) *any breach, non-observance and/or non-performance by the Subcontractor of such obligations;*
- (b) *any act and/or omission of the Subcontractor which gives rise to the Contractor incurring liability to the Employer; and*
- (c) *any claim, loss, damage and/or expense due to, or resulting from, any act, omission, negligence or breach of duty by the Subcontractor.*

Note, the precise wording of this indemnity must be tailored to the equivalent Main Contract wording.

# Possible solutions

[●].1 *Insofar as he has not already done so, the Subcontractor shall immediately effect and thereafter maintain throughout the duration of the Subcontract Works:*

- (a) *all insurances required under Law including [Employer's Liability insurance] and [Motor Liability] insurance as stated in Appendix [●]; and*
- (b) *until the twelfth anniversary of the Completion Date, professional indemnity insurance, as stated in Appendix [●] in respect of his professional duties in the performance of its professional obligations under this Subcontract.*

[●].2 *The insurances referred to in Clause [●].1 shall be effected with such insurers, and in such form and substance, as may be approved from time to time by the Contractor.*

# Possible solutions

*[●].3 The Subcontractor shall not take any action or fail to take any action or (insofar as it is reasonably within its power) permit anything to occur which would entitled any insurer to refuse to pay any claim made under the insurances referred to in Clause [●].1.*

*[●].4 The Subcontractor shall provided to the Contractor, upon reasonable request from time to time, proof (in the form of a letter or certificate from the Subcontractor's insurer or insurance brokers) that all relevant premiums in respect of the insurances referred to in Clause [●].1 have been paid and that the policies remain in force and are held by the insured without encumbrance.*

# Possible solutions

- The general position underscores the importance to MC of:
  - due diligence, i.e. investigating NSC's capacity to comply with his obligations under the subcontract, and
  - reliance where appropriate on the right of reasonable objection.



# **Delay or Disruption to the Works**



# **Red Book 4<sup>th</sup> Clause 44**

The extension of time shopping list simply does not include delay caused by NSC as a ground for an extension of time.

# SIACC

## Clause 23

MC may be entitled to an extension of time for delay caused by:

- an Architect's instruction under Clause 28 in regard to Contingency Sums
- An Architect's instruction under Clause 29(3) to subcontract with an NSC with whom MC has raised a valid objection

Otherwise there is no basis for an extension of time for delay caused by NSC later on in the course of the Works.

# Standard problems

If MC does not secure suitable amendment of these provisions then the problem MC will encounter is that he will carry the risk of delay to the Works and resulting delay cost caused by NSC's acts, defaults and/or breaches of contract.

Emp. is unlikely to agree to expand the extension of time shopping lists and the most promising risk management solution therefore is for MC to lay-off the exposure to liquidated damages through a specific indemnity in the Subcontract conditions.

# Red Book 4<sup>th</sup> & SIACC

## Possible solutions

[●].1    *The Subcontractor acknowledges that failure to achieve Completion of the Subcontract Works by the Subcontract Completion Date may cause the Contractor to suffer prolongation and other costs, expenses and losses.*

[●].2    *Without derogating from the generality of Clause [●].1, the Subcontractor acknowledges that the Employer shall be entitled to recover from the Contractor liquidated damages, calculated at the rate stated in Appendix [●] to the Main Contract Conditions, if the Main Contract Works remain incomplete at the latest date for completion of the Main Contract Works pursuant to clause [●] of the Main Contract Conditions.*

# Red Book 4<sup>th</sup> & SIACC

## Possible solutions

*[●].3 The Subcontractor shall indemnify the Contractor for any costs, expenses and losses referred to in [●].1 hereof and a fair proportion of any liquidated damages referred to in [●].2 hereof if and to the extent that the delayed completion of the Main Contract Works was caused (in whole or in part) by the Subcontractor, which sums shall be payable on demand as a debt.*

# Insolvency

# Standard problems

Under the SIACC, MC carries the risk of delay to the Work due to the insolvency of NSC. This is because, unlike some standard form building contracts (e.g. in Britain and Hong Kong) SIACC does not require the Arch. to replace an insolvent NSC.

It is unclear whether the Red Book 4<sup>th</sup> requires a re-nomination, and this is probably why we find references to the '*named subcontractor*'. Named subcontractor provisions represent an attempt by Emp.s to enjoy the power to select without any duty to re-nominate in the event their '*named subcontractor*' becomes wholly disabled from discharging subcontract obligations.

# Standard problems

Therefore MC is left to pick up the pieces and procure the completion of the Works.

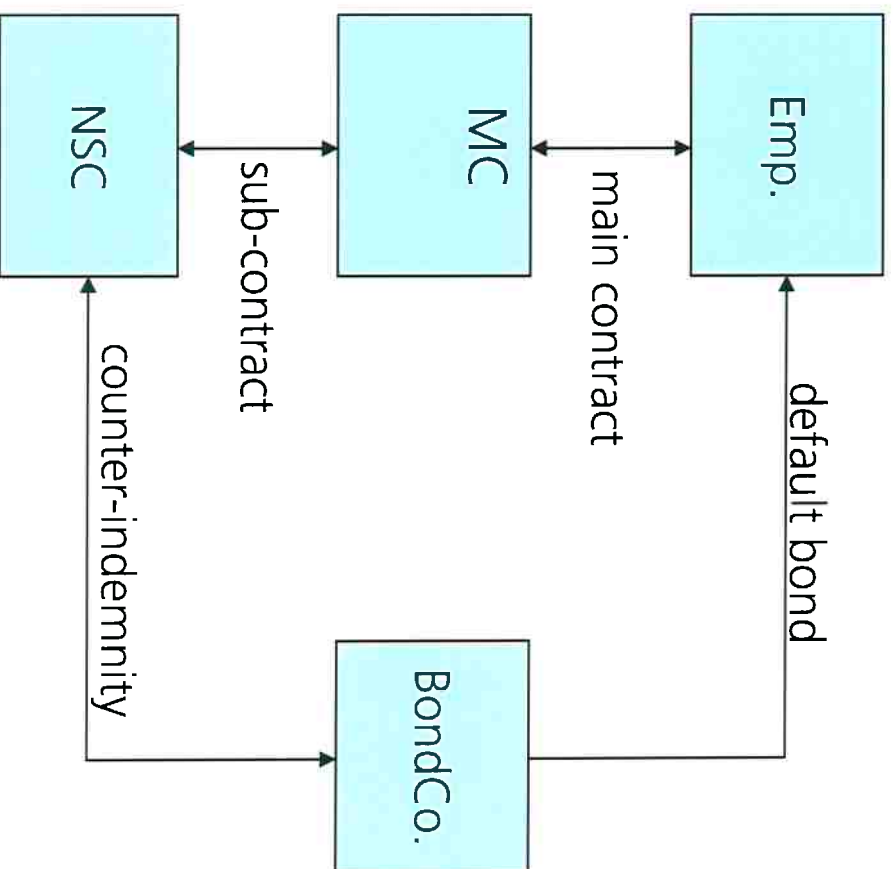
The most promising solution to the risk of NSC insolvency is, of course, bonding.



# **Standard Problems Project bonding**

Nominated practice in East Asia does tend to lead to complex bonding issues, as the following contemporary scenario illustrates.

# Standard Problems Project Bonds

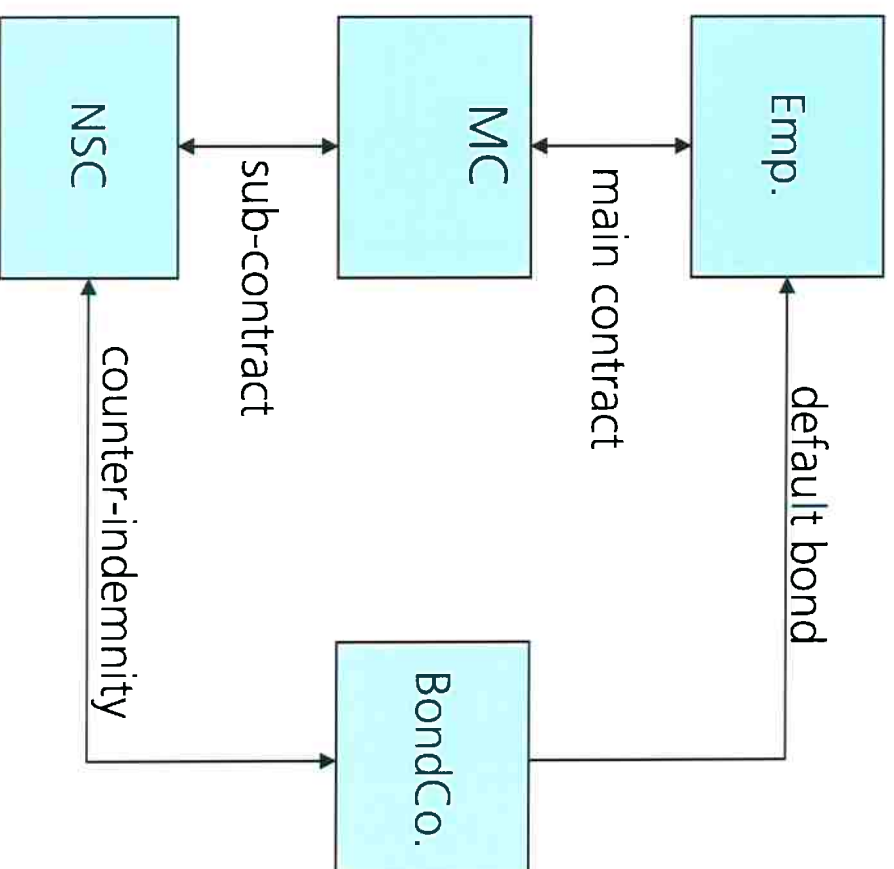


Emp. nominated building services specialist NSC for a critical portion of the main contract works.

Emp. stipulated to MC the terms conditions of the subcontract. This did not include the provision of a bond for the benefit of MC. One such term of the subcontract was, however, that NSC must procure one in favour of Emp.

MC did not object to NSC and did not independently require NSC to procure a bond in favour of MC.

# Standard Problems Project Bonds

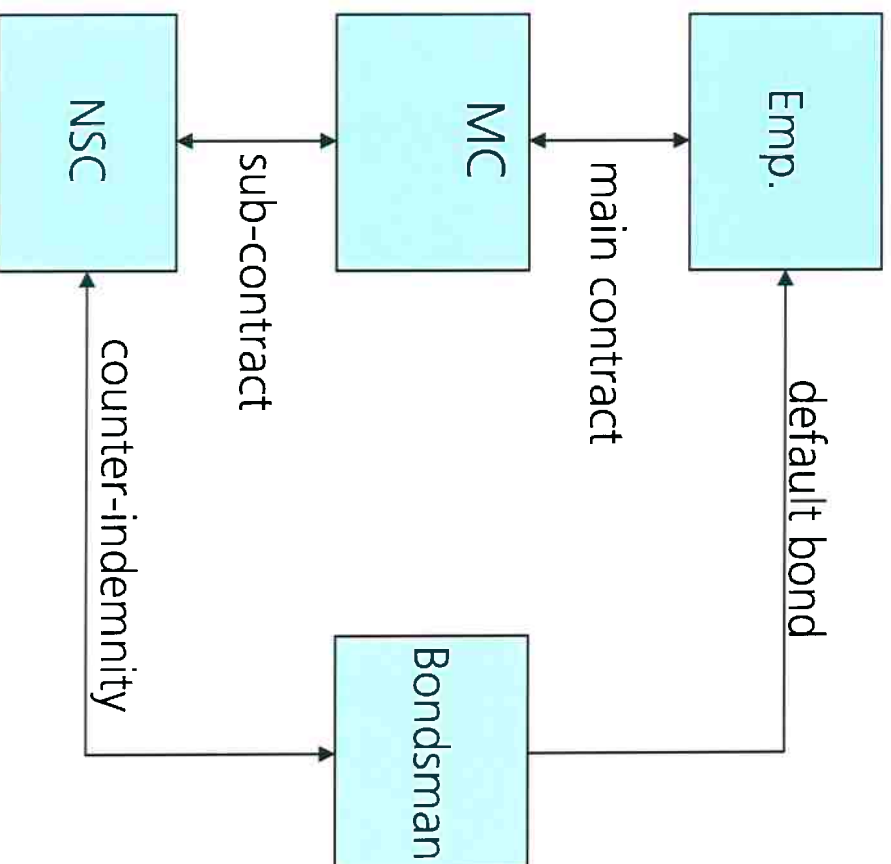


NSC defaulted and, as a result, MC was faced with additional costs to complete the Works.

Emp. called the bond and, pursuant to the main contract conditions, used the funds to contribute to MC's additional cost of completion.

NSC reimburses BondCo. and brought a claim against MC for an account of surplus bond monies under the English Law '*Cargill implied term*'.

# Standard Problems Project Bonds



Question - In order to defend the claim brought by NSC must MC prove that his costs to complete the Works were a proper basis for Emp.'s call on the bond?

Solution: Reasonable objection?

# Possible solutions

## 59.2 Nominated Subcontractors: Objection to Nomination

*The Contractor shall not be required by the Employer or the Engineer, or be deemed to be under any obligation, to employ any nominated Subcontractor against whom the Contractor may raise reasonable objection, or who declines to enter into a subcontract with the Contractor containing provisions:*

- a) that in respect of the work, goods, materials, Plant or services the subject of the subcontract, the nominated Subcontractor will undertake towards the Contractor such obligations and liabilities as will enable the Contractor to discharge his own obligations and liabilities toward the Employer under the terms of the Contract and will save harmless and indemnify the Contractor from and against the same and from all claims, proceedings, damages, costs, charges and expenses whatsoever arising out of or in connection therewith or arising out of or in connection with any failure to perform such obligations or to fulfil such liabilities, and*

# Possible solutions

## FIDIC

b) *that the nominated Subcontractor will save harmless and indemnify the Contractor from and against any negligence by the nominated Subcontractor, his agents, workmen and servants and from and against any misuse by him or them of any Temporary Works provided by the Contractor for the purposes of the Contract and from all claims as aforesaid, and*

c) *that the nominated Subcontractor shall provide to the Contractor a guarantee or performance bond for the due performance by the Subcontractor of all of its obligations under the subcontract in such form acceptable to the Contractor issued by a bank or insurance company satisfactory to the Contractor, such bond to be for [ 1 per cent of the subcontract price and shall be released on the date of issue of the final certificate under the subcontract.*

# Possible solutions

## SIACC

29.

...

### **Objections to nomination**

(2) Provided that the Contractor shall be entitled to object to a Nomination Instruction either:

...

# Possible solutions

## SIACC

(b) Because, in the case of Nominated Subcontractors or Suppliers, or Designated Subcontractor or Suppliers whose work is the subject of a P.C. item, the terms of subcontract offered by the selected subcontractor or supplier are unsatisfactory in that:

..., or

(ix) there is no requirement for the provision to the Contractor a guarantee or performance bond for the due performance by the Nominated Subcontractor or Supplier, or Designated Subcontract or Supplier (as the case may be) of all of its obligations under the subcontract in such form acceptable to the Contractor issued by a bank or insurance company satisfactory to the Contractor, such bond to be for 1 per cent of the subcontract price and shall be released on the date of issue of the final certificate under the subcontract.



# CONCLUSION

- Nomination is a risky process for MCs and it is open to abuse by Emp.s and their consultants.
- Japanese contractors should therefore tread carefully when nomination is being proposed in foreign construction projects.
- The procurement policies of funding agencies, such as the World Bank and ADB guidance documents, offer no special protection to MCs with regard to NSCs and so every opportunity must be taken to negotiate changes to the standard NSC provisions in the Red Book/SIACC and the corresponding subcontracts.



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