

INNOVATIVE CONTRACTING TECHNIQUES AND REASSESSING YOUR CONSTRUCTION CONTRACT IN LIGHT OF THE DEMISE OF MAINZEAL

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WHAT I WILL COVER

- Innovative contracting techniques: ECI, BIM, Panels and EPCM
- Owner protections against insolvency of its main Contractor

WHY IS THIS RELEVANT?

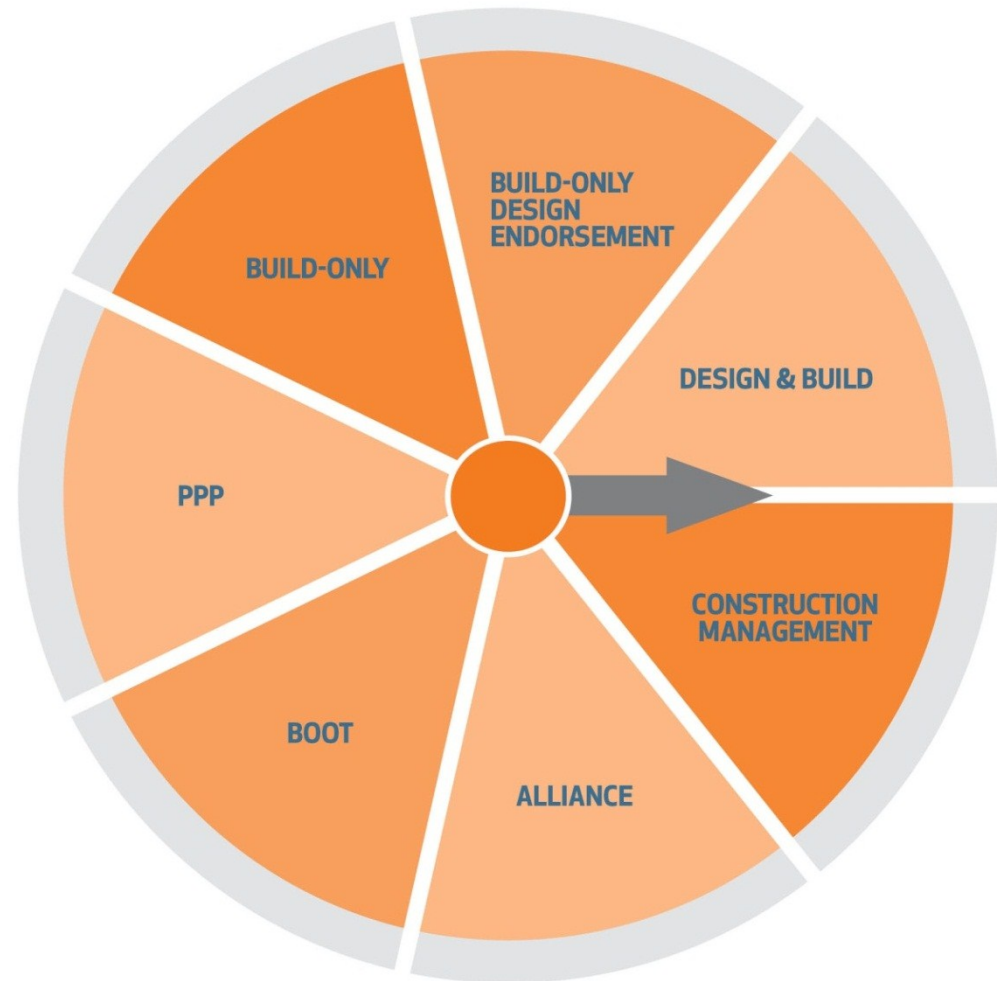
- Construction tsunami heading our way due to the Christchurch rebuild – traditional procurement techniques may not stack up
- The demise of Mainzeal

WHO AM I?

- From the West Coast of the SI, via Abu Dhabi (Middle East), London and Melbourne
- Returned to NZ last year, following running the construction practice of global law firm, Shearman & Sterling
- First hand involvement in some globally significant infrastructure construction projects, including through the GFC
- Bring international knowledge, experience and insights

PART A: INNOVATIVE CONTRACTING TECHNIQUES DEVELOPMENT MODEL CHOICES

**Procurement method:
typically
competitively bid**



INNOVATIVE PROCUREMENT METHODS – ECI, BIM, PANELS AND EPCM

The Challenge

- **Capacity** and **capability** constraints are of major concern to many Owners due to the Christchurch rebuild. This is a **national issue** – it is not just confined to Christchurch
- Consultants and Contractors may even start **declining to bid for work** once the Christchurch rebuild gains momentum – bid costs and opportunity cost can be very high with no guarantee of success



- Owners that can **move quickly** are likely to reap the rewards of having a **greater pool of Consultants and Contractors** to choose from at **lower prices** - significant **inflationary pressures** will come to bear on the New Zealand construction industry due to the Christchurch rebuild
- These realities may force Owners to **deviate from traditional tendering** – they may have to entice Consultants and Contractors to their project



Early Contractor Involvement (ECI)

- **ECI may feature prominently** in the Christchurch rebuild and perhaps elsewhere in New Zealand. Features of ECI typically include:
 - **Stage 1 (Pre-Construction)** – A Contractor is introduced at the **planning and design phase**. It enters into a pre-construction services agreement with Owner under which it works up design with Owner and its Architect and puts forward an offer – including price and schedule – to undertake Stage 2. Owner would typically insist on Contractor getting at least 3 to 4 quotes for significant work packages

- **Stage 2 (Construction)** – If Contractor's offer is accepted, Contractor enters into a **Design & Build Contract** with Owner. If Contractor's offer is not accepted, Owner can ask other Contractors to put forward an offer to execute the development
- So Contractor is effectively an **additional consultant** early on in the process and then resumes the traditional design and build role should its offer be accepted

- **Advantages** of ECI include:
 - Contractor is likely to see the approach as favourable as it has a chance to **embed itself in the project** – it is almost Contractor's project to lose – compared to a tender process with potentially high associated costs and no guarantee of success
 - It fosters a **collaborative working relationship**
 - Contractor's **design risk is minimised** given its involvement in the preparation of the same, which should result in **lower pricing**
 - There could also be significant **schedule savings**: early input from Contractor could result in a truncated works programme and if its Stage 2 offer is accepted then a tender process would be avoided which would result in further schedule savings

- **Disadvantages** of ECI include:
 - **Higher upfront costs** for Owner given the early engagement of Contractor (although such costs could conceivably be offset – at least in part – if Contractor submits a lower contract price for Stage 2 as a result of it participating in the design process)
 - In reality it may be **difficult to reject Contractor's Stage 2 offer** and go out to the market, as significant time could be lost with no guarantee of success (particularly in a hot contracting market)



- **ECI is not new.** In fact our lawyers have worked on ECI projects in sectors such as healthcare and oil and gas, both in New Zealand and overseas



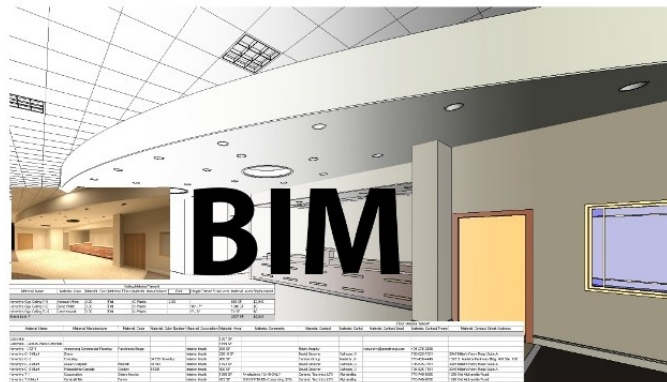
Greenlane Hospital



Waitara Valley Methanol Plant

Building Information Models (BIMs)

- The collaborative nature of the ECI approach also sits well with the use of a BIM. BIMs are currently quite topical. Some of the features of a BIM are as follows:
 - BIMs envisage **virtual construction of the facility** before it is built, which gives Owner comfort that the facility will meet its expectations in terms of the **physical and functional** aspects of the facility and gives Contractor certainty around the construction phase



- Owner, its Consultants, Contractor and its proposed Subcontractors and Suppliers can **all input important information** into the model before construction commences e.g. design, engineering, materials, equipment (right down to the manufacturer and part number), quantities and pricing
- **Simulations can be run** to assess the impact of changes to the facility – so BIMs are a very useful tool for decision making e.g. in terms of cost management during both the construction and operations and maintenance phases



- BIMs not only assist during the pre-construction and construction phases – they can be **very useful during the operations and maintenance phase**. For instance, the model and associated data bank may enable defects to be readily identified and isolated
- It is an **involved process** to develop a BIM model

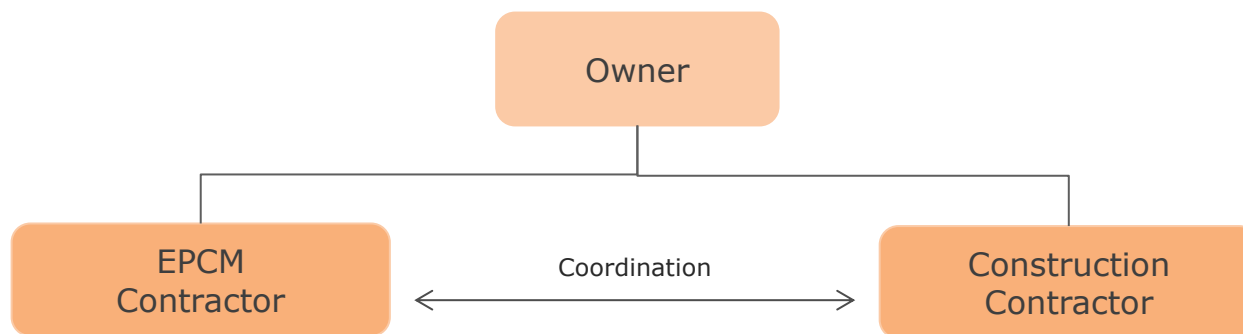


Panels

- Owners with large construction programs will be likely to have panels of **approved Consultants and Contractors**, and may – instead of going down the traditional tender route – opt to **select a project team from the panel firms** for a particular construction project and adopt the ECI approach
- The panel approach will not, however, guarantee that Owner will get its desired project team as **people will become unavailable** due to other work commitments
- Ideally Owner will have **pre-agreed contractual terms and conditions** with the panel Consultants and Contractors to cut down negotiation time – only the scope and commercials e.g. lump sum price and schedule, need to be agreed

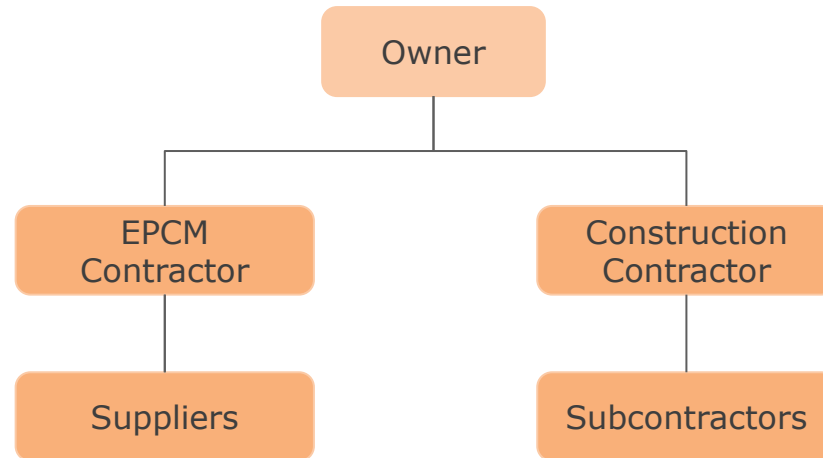
Engineering, Procurement and Construction Management (EPCM)

- It will be interesting to see if the EPCM model gains any traction during the Christchurch rebuild
- Typically there are **two 'main' contracts under the EPCM model**: a consultant/contractor is engaged to carry out the design and engineering, procure various materials and oversee construction; and a separate contractor is engaged to procure the balance of the materials and build the facility

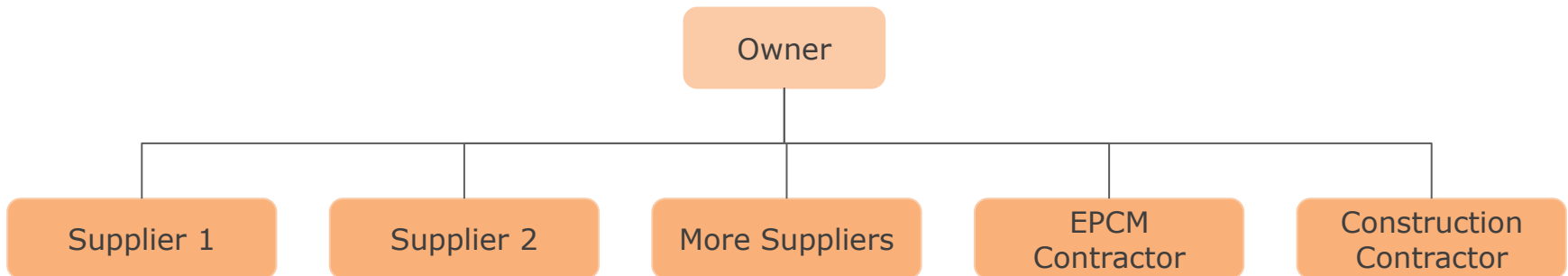


- The EPCM model – which is often seen in the oil and gas industry – can be suitable where a consultant/contractor is **well placed** to do the design, assist with procurement and oversee construction but is **unable or unwilling** to build the facility
- There can be **significant interface risk** for Owner under the EPCM approach – each ‘main’ contractor is not usually liable for the performance of the other ‘main’ contractor – but the flipside of this is that it should result in cost savings to Owner

Scenario 1: (less interface risk)



Scenario 2: (more interface risk)



PART B: REASSESSING YOUR CONSTRUCTION CONTRACT IN LIGHT OF THE DEMISE OF MAINZEAL

- Security
- Subcontractor continuity guarantees
- Subcontractor collateral warranties
- Paying Subcontractors direct
- Suspension by Subcontractors
- Materials
- Cashflow on termination
- Immediate termination
- NZS 3910 anomaly

SECURITY

- Parent Company Guarantee
- Performance Bond
- Advance Payment Bond
- Retention Bond / cash retentions
- Form of the bond important: how 'liquid' or 'callable' is the bond?
- Back-ending payments e.g. withholding a significant portion of the contract price until Practical Completion

SUBCONTRACTOR CONTINUITY GUARANTEES

- Consider requiring Contractor to **procure** duly signed Subcontractor Continuity Guarantees from key Subcontractors, and requiring these to be **delivered** to Owner at an early stage e.g. before the Contractor is paid for anything invoiced by the applicable key Subcontractor
- Under a Subcontractor Continuity Guarantee the Subcontractor commits to Owner to **continue to perform** its works for Owner following termination of the Contractor. This is preferable to relying on a contractual clause obliging the Contractor to assign subcontracts to Owner

SUBCONTRACTOR COLLATERAL WARRANTIES

- Consider requiring Contractor to **deliver** Subcontractor Collateral Warranties to Owner at an early stage e.g. before Contractor is paid for anything invoiced by the applicable Subcontractor
- Under a Subcontractor Collateral Warranty, the Subcontractor **warrants the performance of its work** to Owner. This could prove important should Contractor go insolvent, as the warranties could be used to compel the Subcontractor to remedy defects attributable to it
- The Subcontractor Collateral Warranty and Subcontractor Continuity Guarantee could be covered in **one document** (instead of having two separate documents)

PAYING SUBCONTRACTORS DIRECT

- Consider requiring Contractor to provide **evidence that it has paid all amounts due to Subcontractors**, and entitling **Owner to pay Subcontractors direct** where they have not been paid amounts due to them (such payments would typically count towards payment of the contract price)



SUSPENSION BY SUBCONTRACTOR

- If a Subcontractor is not being paid (which may be an indicator of financial difficulty of Contractor), it may be entitled to **suspend** under the Construction Contracts Act
- Many contracts we see require Contractor to **notify** Owner of any such impeding suspensions and **enable Owner to pay the Subcontractor direct** in order to avoid suspension



MATERIALS

- Consider **not paying** for off-site materials – if Contractor goes insolvent and materials that have been paid for by Owner are not at the site, then it may be more difficult for Owner to successfully recover the materials, especially if the materials are overseas
- If Owner does agree to pay for off-site materials (which is often unavoidable), it should consider requiring Contractor and the applicable Subcontractor to first deliver to it a duly signed **bailment agreement**. Such agreements typically provide as follows:
 - upon payment by Owner for the materials, **title in the materials vests in Owner** and the Subcontractor holds the materials as bailee for Owner

- the **Subcontractor agrees:**
 - to segregate the materials from other materials
 - to mark the materials in a way that makes it clear that they are owned by Owner
 - to allow Owner to inspect the materials and remove them from the Subcontractor's premises
 - not to remove the materials from its premises, except to deliver them to the construction site when required
 - to insure the materials
 - to prevent damage to the materials, and
 - ownership will transfer to Owner free of any security interest
- Consider beefing up the '**no security interest**' type requirements in relation to materials to try and safe-guard Owner's interest in the same e.g. requiring Contractor to ensure that title to Owner's materials is reflected in all subcontracts
- Note comments below on PPSA

CASHFLOW ON TERMINATION

- Consider inserting a '**termination account**' regime
- Under such a regime Owner could, soon after termination of Contractor, **estimate** the additional cost-to-complete the works and such amount would then become a **debt due and payable** by Contractor to Owner even though Owner may not have started incurring such cost
- This is intended to ensure that Owner is '**in funds**' to complete the works
- The money would typically come from a **call under a bond** - the debt due and payable would crystallise a legitimate claim under the bond (subject to the terms of the bond itself)

IMMEDIATE TERMINATION

- Consider having the ability to **terminate** the contract **immediately** upon insolvency of Contractor, instead of having a cure period
- **Cure periods** can create **uncertainty** and may **delay** completion of the project



NZS 3910 ANOMALY?

- There may be an **anomaly** in Clause 14.2.5 of NZS 3910
- In particular, it would seem appropriate for that Clause 14.2.5 to apply in respect of a termination under Clause 14.2,2 as well as under Clause 14.2.1
- Accordingly, "or 14.2.2" could be inserted after "14.2.1" in Clause 14.2.5

PASSING COMMENTS ON THE PPSA

- The Personal Property Securities Act (**PPSA**) determines the **priority of security interests** in the same personal property
- It provides for the **enforcement of security interests** in personal property
- It established a **register** of security interests in personal property
- It distinguishes between General Security Agreement (**GSA**) holders, and Purchase Money Security Interest (**PMSI**) holders (essentially being Retention of Title (**ROT**) creditors)

- **Why the distinction** between a general security and a PMSI?
 - **General rule** is that the first secured party to register or take possession has priority
 - PMSI holders can benefit from an **exception to that general rule**
 - PMSI holders can gain "**super-priority**" ahead of other secured parties

- **Who can register** a PMSI?
 - "purchase money security interest" usually means "a security interest taken in collateral by a seller to the extent that it secures an obligation to pay all or part of the collateral's purchase price"
 - e.g: Subcontractor supplying goods to main Contractor under a **ROT** provision which secures an obligation of the main Contractor to pay the Subcontractor for the goods
 - another example is where goods are **leased** for a term of more than **one year**

- **Subcontractors**, in particular, **should take note** that if they own equipment that they lease for more than one year to a Contractor, then they should register a PMSI in respect of the equipment, otherwise a secured creditor's claim to the equipment may take priority over the Subcontractor's interest, even though the Subcontractor is the legal owner of the equipment. The *Portacom* case illustrates this point.

- **How to register** a PMSI?
 - Timeframe for registration **crucial** (if the timeframe is not adhered to, "**super-priority**" **will be lost**):
 - Section 73 where collateral not inventory or intangibles - 10 days from possession
 - Section 74 for inventory and intangibles - no later than possession
- So how is this **relevant** to an Owner?

— Materials:

- The construction contract will usually say that materials either paid for by Owner, or delivered to the site, **are owned by Owner**
- However, if a Subcontractor has a registered general security or PMSI under the PPSA in respect of materials it supplied, there is a **risk** that the Subcontractor's interest will take **priority** over the provisions in the construction contract i.e. the Subcontractor could be entitled to the materials if they are not affixed to the site
- Owner should obtain **assurance** from its main Contractor that they are entitled to onsell and transfer title to the materials **free from any encumbrances**, such as any security interests (could cover off directly with Subcontractors in a Continuity Guarantee or Collateral Warranty)



— Construction equipment:

- The construction contract may entitle Owner to **use construction equipment** that is on the site, following termination of its main Contractor for its insolvency

However, if a Subcontractor or financier has registered security under the PPSA in respect of any such construction equipment e.g. equipment it may have leased to the main Contractor or financed, that interest is **likely to take priority** over the provisions in the construction contract i.e. the Subcontractor or financier will likely be entitled to the construction equipment



QUESTIONS?

