What makes a Construction Contract Bankable?

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October 2015

Bankability is determined on a case-by-case basis as each project is different, but there are certain benchmarks that generally need to be satisfied for a construction contract to be bankable. This article sets out some generic but key requirements that owners should ensure their construction contract possess, and which lenders should look for when deciding to lend, to ensure that the construction contract properly protects their investment.

Identity of the Contractor

Be confident that the contractor has adequate financial and technical resources to fulfil its contractual obligations and to meet any liability under the construction contract if the project encounters difficulties.

Although the issue of liability is partially addressed by insurance and performance security (discussed below), this is not enough and you should still be satisfied of the contractor's financial position and the robustness of the contractor's balance sheet. If the contractor is a subsidiary, you may consider requiring a parent company guarantee to cover any liability that it may incur.

A parent company guarantee may also extend to guaranteeing the contractor's performance if the developer has concerns over the ability of the contractor to deliver the project – this is particularly relevant if a SPV has been incorporated for the project.

Form of Procurement

Although there are various different ways of procuring a construction project, funders typically favour a 'turnkey' solution under which the contractor takes full responsibility for the design, construction, testing and completion of the project. This is a departure from the 'construct only' procurement approach which is popular in the Middle East.

A design and build structure provides a 'single point responsibility', meaning that the contractor will be unable to absolve itself from responsibility on the basis that a third party was liable for the breach and this point makes the identity (and creditworthiness) of the contractor all the more critical.

Construction Issues

If you are to use design and build the expected project that you want to be delivered is detailed in a brief, more commonly known as the 'Employer's Requirements'. You will need to ensure that the Employer Requirements contain a clear output specification and the contractor should be responsible for satisfying its requirements.

Additionally, the contractor should be required to provide express warranties regarding the design and construction of the project. For example, the contractor should warrant that the project will be designed in accordance with established principles and the law and that it will be fit for its intended purpose. Additionally, all construction works should be performed in accordance with best industry practices.

Payment Regime

The Contractor’s remuneration requirements must be subject to a clear payment regime. Payments upon the completion of designated milestones are usually preferred by funders as these provide the greatest comfort that the contractor has actually satisfactorily performed the works for which payment is claimed.

A frequently used alternative is for the contractor to be paid on an interim (i.e. monthly) basis against the actual (and substantiated) progress achieved.

Regardless of the payment mechanism, the funder will generally require that a payment is only made if it is approved by a certifier appointed or approved by the funder. This may be an engineer, architect, project manager, quantity surveyor or other appropriate professional. The construction contract needs to make provision for this (including, from a practical perspective, ensuring that the funder’s certifier has access to the site).

Any advance payment which is made to assist the contractor with its mobilisation needs to be secured by an advance payment guarantee.

Contract Price

Certainty of the contract price is essential and the contract price should be for a fixed lump sum amount, which may only increase in narrowly defined circumstances. These may be restricted to variations (which may require the funder’s consent) and acts of prevention by the Employer.

Completion

The requirements for the project to be taken over needs to be clearly set out (particularly the tests on completion that need to be satisfied) and funders will usually only permit the works to be taken over if the funder’s certifier agrees that the works have indeed been completed in accordance with the contract.

Time Completion

The project will only become a revenue generating asset once it is complete so it is vital that the construction contract has a fixed time for completion.

As with the contract price, the contractor should only be entitled to an extension of time in a limited number of clearly defined situations (i.e. the contractor may be required to accept risks which are beyond its control such as changes in law or unforeseen ground conditions) but it is noteworthy that contractors will price additional risk that they are required to assume.

It is important that a late completion penalty be payable if the project fails to achieve completion by the agreed completion date. The amount and rate of the penalty needs to be carefully considered and should cover financing costs as well as any other loss that the developer is likely to incur due to the delay (although it is customary for an overall cap of 10% of the contract price to apply).

Depending on the nature of the project, performance liquidated damages may also be required if the required output specification is not achieved. An event of termination will usually arise if certain minimum output thresholds are not achieved by a longstop date.

Security

On demand performance bonds and retentions (which may take the form of a retention bond) will typically be required, and these may be assigned to the funder.

Additionally, the funder will typically require a collateral warranty from the contractor, which enables the funder to enforce the construction contract against the contractor in the event of any breach and to provide the funder with step-in rights.

Step-in rights are important as they allow the funder to elect to remedy any breach of the construction contract by the developer (typically a failure to make payment), preventing the contractor from suspending or terminating the contract.

Insurance

The construction contract should include all customary insurance requirements (which should be approved by an experienced insurance broker). The usual insurance policies include professional indemnity insurance (if the contractor has design responsibility), contractor's all risk insurance, public liability insurance and workers' compensation insurance.

The developer and the funder would typically seek to be named as the beneficiary under the insurance policies, or as a class of insured, while the insurers should be required to waive their rights of subrogation to ensure that recoverability under the insurance policies is not compromised.

Liability

Ideally from the developer's and the funder's perspective, the construction contract would not be subject any caps on or exclusions of liability. However, contractors usually insist that their total liability under the construction contract is limited.

Notwithstanding the ability under some jurisdictions for contractual caps on liability to be opened up and reassessed by a court or arbitral tribunal, funders normally should ensure that that the cap on liability is not less than the amount they have injected into the project and that no exclusions of categories of loss (such as the exclusion indirect or consequently losses) unintentionally cut across the funder's ability to recover from the contractor.

It should be clear if the limit includes or excludes insurance proceeds and that the limit does not apply to certain loses (for example a loss due to fraud or wilful and reckless act of the contractor).

Conclusion

There are many risks in undertaking a construction project. Funders should carefully review all construction contracts that they are lending against to minimise their exposure and to ensure that they know the risk that they are actually taking on when lending.

Equally, developers should take care and ensure that the construction contract provides adequate protection.

It is difficult to renegotiate a contract if a project subsequently requires funding (as can be the case) so it is best to ensure that the contract is bankable from the outset.