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WHAT ARE SOME OF THE CHALLENGES FACING CONSTRUCTION CONTRACT NEGOTIATION IN THE "POST-COVID" ERA?

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The construction sector, which has proven to be one of the most resilient industries throughout the pandemic, is accustomed to cyclical downturns, but the speed and strength with which Covid-19 hit is unprecedented.

Supply chains have been severely disrupted, and the impact of lockdowns has forced some construction companies to restructure their debts, seek new sources of capital, and even risk insolvency proceedings. As countries begin to recover from the pandemic and initiate a return to the workplace, the construction industry will move forward taking the lessons learned over the last year.

This article aims to highlight how Covid-19 is impacting the construction industry, as well as to assess the effects that the current pandemic may have on contract negotiation and the fulfilment of each party's obligations.

a) Legal implications: doctrine of force majeure

During Covid-19 many contractors have notified project owners of their intention to invoke the doctrine of force majeure as justification for suspension, shutdowns, possible delays, and cost increases in their construction projects. As a result, project owners have been forced to adapt to significant challenges and discover project-by-project solutions to mitigate the delays and other impacts caused by Covid-19 whilst protecting their commercial interests.

On the contractual side, the legal implications vary from country to country and contract to contract. Before making a decision on these queries and requests from the contractors, the project owners should analyze (i) whether force majeure exists as a contract remedy, and if not, (ii) whether a legal concept shall apply.

A force majeure clause allows for - in general - a number of unforeseeable events beyond the control of the parties, e.g., wars, natural disasters, pandemics which, if they occur, may prevent the temporary or definitive fulfilment of contractual obligations. The parties may then agree that following the verification of such events, no contractual breach is deemed to exist or that the contractual penalties for late performance or non-performance will not be applied.

The verification of a situation of force majeure may not in itself allow the termination of the contract but only the possibility of the unfulfilled contractual obligations being carried out within a different manner and over a longer period of time. A case-by-case analysis should be performed.

As the impact of Covid-19 and legislative responses continue to evolve, *it is prudent to ensure that both parties understand the specific nature of their contractual arrangements to determine whether a force majeure event exists and may be relied upon in particular circumstances*.

b) Challenges in price negotiation (lump sum contracts)

Project owners often procure major construction projects on a fixed price *(lump sum turnkey contract)* whereby the contractor is responsible for all the construction aspects of the development. Below, we consider the main contractual challenges we have been facing recently in price negotiation, and how the parties have been handling this situation regarding contract negotiations and key takeaways from this recent experience.

- Price

Each negotiation has its own framework and specificities, however, both (*i*) the commercial alignment required between the tight deadlines applied today by suppliers to contractors; and (*ii*) the timings of contract negotiations make it highly unlikely that contractors will be willing to agree to accept to execute lump sum contracts while there is not yet clarity or definition regarding the project to be executed, especially in cases where negotiations run parallel to the licensing procedure.

As would be expected, in situations in which (*i*) there are large price fluctuations; and (*ii*) suppliers are reluctant to fix the long-term price of materials, contractors have been trying to allow for such variation and market risk in the construction contract, making the negotiation around a firm fixed price and the non-revisability of the price even harder.

Over the last year, negotiations regarding possible price variation have gained even greater relevance, and parties have tried to (*i*) find contractual mechanisms for sharing the risk; as well as to (*ii*) seek an alignment of interests and incentives.

In addition to this, advance payment arrangements have become commonplace in construction agreements. The usual rationale for these payments is to assist the contractor with the cash flow required to cover initial expenses. However, the project owner may not benefit from any saving in escalation costs by making an early payment.

This situation usually opens the door to a parallel negotiation concerning the guarantees which the contractor should provide in order to secure an advance payment from the project owner.

From a legal perspective, it is therefore essential to ensure that each party's interests are clearly aligned and represented in the drafting and negotiation of the contract, in particular, any and all default mechanisms.

- Additional works

Regarding the criteria for any additional works, the standard procedure is to apply the same unit prices and partial deadlines for the same type of work and materials. This has been the contractual principle normally applied to construction contracts in respect to additional work already contained in the contractor's offer.

Recently, however, we have experienced some difficulties with contractors agreeing to apply the same unit prices specified in the contract for the same type of work and materials. In fact, many construction companies argue that (*i*) they are operating today without substantial capital reserves; (*ii*) many items are subject to huge supply shortages; and (*iii*) materials have undergone considerable price increases.

To circumvent this situation and find a middle ground, the contractual parties have sought to implement subsidiary mechanisms allowing the parties to share the market risk in case of a sharp variation in material prices. Once again, the legal team should guarantee that the issue of shared risk is carefully addressed in contractual proceedings.

c) Conclusion

Overall, it is clear that there is an unfortunate combination of *"post-pandemic"* factors that are currently affecting the actions of contractors and other players in the construction industry. The disruption and financial instability caused by Covid-19 has led to contractual negotiations being more challenging, especially regarding the pricing in lump sum contracts.

Timing, definition, and clarity on the scope of works to be carried out, and alignment between the contractor supply chain and the commercial incentives of the construction contract are key in order to ensure that the construction industry is able to overcome the challenges imposed by this post-covid era. It remains to be seen whether, or not, this will come about. ■