

# Risk Mitigation In Construction Contracts

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**Abstract** - The paper aims to shade intensive lights over risks mitigation and its related aspects embedded with a construction contract . For this purpose , an in-depth study of different types of risks which generally arisen in large sized construction projects is presented within the paper . For making the context clear , the paper elaborates some significant information about construction contract , starting with definition of contract, and different parties which are generally involved within a construction contract . In this section , the nature of different construction contracts is also discussed , which becomes a prime reason behind different types of risk in the contract . Further , the paper discusses different types of risks availed by different parties . Further section of the paper is related with the risk allocation in a construction contract . The section explores disclaimer method for transferring risk from one party to other . Furthermore different roles played by different parties in the mitigation of risks in a contraction contract are also explained in the paper .

**Key Words:** Contract , Construction Contract , Contract Risks , Risk Allocation , Risk Mitigation Strategies .

## 1. INTRODUCTION -

In existing uncertain and highly fluctuating business environment , risk identification and its proper allocation and mitigation has become an integral aspect of business management practices undertaken by commercial business organizations . In the same manner , proper risk allocation and risk minimisation becomes quite essential

and crucial in the industries like construction in which , a huge amount of investments are done by management of business organizations . The failure of proper identification and allocation of risks in major civil and other types of construction projects can lead the concerning parties to pay some direct costs as they are needed to invest some significant amount of time, cost and efforts in construction project . Owing to this reason , it becomes quite essential for management of such types of projects and organizations to undertake some of crucial commercial as well as contractual arrangements for the purpose of allocating and minimizing risks involved within their project . In recent period of time, there are different examples and incidents in which large construction projects have fallen out due to inappropriate management of contractual risks . In the light of this fact, the paper aims to reflect different types of risks involved within a construction contract and different measures employed for the purpose of mitigating risk in the most effective manner so that the entire execution of a project as well as outcomes of the project can be managed. A number of different measures and models have been started to be used in normal practices by construction business organization in order to manage as well as allocate risks involved in construction contract .

## 2. WHAT IS CONTRACT -

A contract is an agreement that is enforceable at law. It is the primary tool through which Institution's govern relationships and understanding with the other party. There are 5 components of a contract, all of which must exist in order for the contract to be legally binding on the parties. These components are:

1. Legal Capacity - The parties to the contract must have the legal capacity to enter into a contract. Legal capacity means that the parties are of legal age and are competent. It also means that the party is a legal entity. Individuals signing the contract must have the authority to bind the legal entity to the agreement.

2. Offer & Acceptance - There must be a genuine intent to enter into the agreement from all parties. Allegations of coercion or intimidation can be grounds to render the contract void.

3. Consideration - To be legally enforceable something of value must be given by one party in return for the promise of action, or omission of action by the other party. Most commonly the consideration takes the form of money, but it could be something else of value (example: goods or services).

4. Legal Purpose - The purpose of the contract must be for legal endeavours (example: contracts for a supply of illegal drugs would not be enforceable at law).

5. Conditions - The contract must specify the terms that will govern the agreement.

## 3. WHAT IS CONSTRUCTION CONTRACT -

In order to mitigate risks involved in a construction project, there is a need of some crucial and effective contractual

agreements and norms which can govern different construction related practices and norms. The legal agreement among different parties involved within a construction project is known as construction contract. The prime purpose of such contracts is to regulate the entire construction project and mitigate different types of risks. As per the definition provided by Housing Grants Construction and Regeneration Act 1996, part II of U.K construction contracts can be considered as a measure of handling different discrepancies which has been presented within a construction project intentionally or unintentionally. As per the section 104 (1) of the act a contract can only be considered as a construction project if it fulfils three different criteria listed as below:

- The project should carry out construction related operations and practices only.
- In the project different construction related operation must be carried out by the concerning party or by other under a subcontract.
- In the project, involved parties either provide their own labour or the labour of others in order to carry out different operations related with a construction project carried out at a large scale.

In addition to this, section 104 (2) of HGCRA 96 has also elaborated the definition of construction contracts. The section elaborates that along with core construction related activities, the construction contract also governs different architectural, design or surveying work related with construction activity. In addition to this, the construction contract also provides the provision of providing advice on different aspects of building construction such as engineering,

interior or exterior decoration, and layout of landscape .

Section 114 (2) of the act also elaborated that construction contracts cannot be applied on a project in two conditions :

- When a claim is demanded for restitution in no contract conditions .
- When due to environmental as well as operational uncertainties , the forcibility of a contract cannot be possible .

#### **4. PARTIES INVOLVED IN CONSTRUCTION CONTRACT -**

In a construction contract there are a number of different parties involved which own their stakes in the contracts. They possess different interests roles and responsibilities within a construction contracts . Different parties involved listed as below :

**Employer or owner of a project:** The employer is a juristic person who owns all rights and ownership of a construction site and project .

**Contractor:** Contractor is the person who comes under the contract with employer to perform different activities related with construction project.

**Subcontractor :** Subcontractors are the party who contracts with main contractor or employer to perform different supportive construction related activities. Subcontracts not only assist the contractor but it also help in providing different supplies, services ,or engineering and specified construction works .

**Tenderer :** Tenderer is a person who submits a tender offer for the purpose of

accomplishing different construction related activities .

**Agent :** Agent is the party who is not the employer or employee but acts on the behalf of the employer of project .

These are some of the prominent parties involved within a construction contract who are responsible for different activities and practices included within a construction project. In the risk allocation process , these parties mitigate different types of risks involved within the construction project .

#### **5. TYPES OF RISKS IN CONSTRUCTION CONTRACTS -**

Some of the risks are common for all the parties involved within contract , while some risks are specifically borne by a specific party. Major risk bearers are owner and contractor.

##### **Risks for the owner of the project -**

As per Abrahamson Principles, owner of the project is known as Principal party. In this context, some critical risks bore by Principal party of the construction contract can be elaborated as below:

(1) Land Acquisition risk: This is the prime risk for the principal of the project. The owner of the project needs to have proper and legal acquisition of the land for his construction project . In the absence of proper acquisition of land, the entire project can be hindered due to different legal obligations.

(2) Insufficient resources : Insufficiency of some of crucial resources like land, finance , human power can also be proved critical risk for a construction project . As construction project are commenced for

a longer period of time, sufficient amount of resources for contingent situation is quite necessary for the owner.

(3) Delay in the project completion : The completion of project on time is one of the major factors of the success of a construction project . Delay in the overall completion of the project due to natural or manmade reasons , can cost quite heavily for the owner of the project as he has to invest a significant amount of money and time in such types of projects .

(4) Increased cost of the project : As generally construction projects are carried out for longer period of time, fluctuations in the overall cost and prices of raw material and labor over such a long period of time are quite natural phenomena. These fluctuations may lead to increase the projected cost of the entire project. Although , principals generally undertake contingency reserves for such type of fluctuations , yet still these increments in cost of the project can be probed quite critical risk for the project owner .

(5) Deficiencies in infrastructure or services : There are a number of different other infrastructural services that can affect the successful completion of the project . For instance , for a residential or commercial construction project, there is need of better electricity and water facilities and better access of road . Deficiencies in infrastructure or services can lead to make the project unsuccessful .

(6) Design and construction defects : Defects in designing and constructing of the project can lead to efficiency of the internal operations and quality of the output of the project . In this direction, the project owner needs to have proper

monitoring and effective evaluation of outcome of the project .

(7) Political risk : Different types of political risks such as rules and regulations of government regarding construction activities , frequent changes in the government and its priorities , and incentives or tax levied by the government over different construction related activities , can hamper the success of construction projects in the most aversive manner .

(8) Market risk : In addition to other risks , risk related with market characteristics as well as trends can also be considered some of the critical risks availed by the owner of the project . Different types of market risks such as advertising of the project, Switching of potential customers of the project towards other alternative projects , and competitive rivalry within the construction industry are some of the prominent market risks which decrease the profitability of the construction project for its owner .

#### **Risks availed by Contractor -**

As per Abrahamson Principles, a contractor is required to face some critical risks throughout the entire stage of a construction project i.e. negotiation over contract terms and conditions, deigning and construction of the building and proper and careful maintenance and follow up the contract in the most effective manner. Some of these risks can be listed as below :

(1) Condition of Site : The existing working conditions of the construction site leads to present risks in front of the contractors to finish the entire project on time. Different natural or manmade problems can lead to delay the project delivery , which is quite problematic aspect for a contractor.

(2) Social conditions : Lack of acceptance of the construction project by the society is the factor that can lead to put question mark over successful accomplishment of the project and viability of project deliverable. There can be some unexpected incidents like labour strike, religious and social belief of local people , and so on, which are to be handled by the contractor only.

(3) Defects in the construction and engineering : There can be some of critical defects in the project which can only be identified in the finished project . The detection of such types of defect becomes quite difficult for the contract during the construction process. These defects can be proved quite critical risk for the contractor of a construction project as these defects decrease the quality of the project .

(4) Increase in the cost : In existing business environment , rise in different types of related cost such as labour wages, cost of raw material for construction and construction equipments are some of critical risks bore by the contractor of the project .

These different types of risks are quite essential for the business organizations to be handled and allocated as in the performance of a construction contract , these risks present different hurdles and problems.

## 6. RISK MITIGATION STRATEGIES -

### **Allocating risk to the party that is in the best position to control that risk :**

A fundamental risk management concept is that owners and contractors should anticipate potential project risks and determine whether it is more advantageous to accept responsibility

for each risk or to allocate responsibility for that risk to another party . From a risk management perspective , it is important to assign a project risk to the party best able to control and manage it. For example ,a project owner will want to allocate the risk that someone is hurt by construction operations to the contractor , who is in the best position to provide a safe work site . A contractor will want to allocate the risk of design errors to the owner ,who often holds the contract with the architect and therefore is in a better position to address and minimize these losses .These are the types of risks that a construction contract should address , so that the parties know in advance who is responsible for what risk .

### **Allocating risk through Indemnity**

**Provisions :** An indemnity provision generally is a section in a contract that requires one party to pay for losses incurred by the other party (and, often, to defend the other party against claims for such losses) as a result of claims made by third parties.

### **Backing up Indemnity Provisions**

**with Insurance :** Contractual indemnity provisions included in contracts are only as good as the indemnitor's ability to honor them . The indemnitor must have the financial ability to satisfy its indemnification obligations . Accordingly, when transferring risk through an indemnity provision , it is important to ensure that the transferee ( or the indemnitor ) has , or is able to procure in a cost- effective manner, insurance coverage sufficient to pay for the assumed indemnity obligations . One caveat to this general principle is that some risks

allocated in an indemnity provision, such as liability arising out of an indemnitor's intentional misconduct, are not insurable due to moral hazard and / or public policy considerations. The lack of Insurability for such conduct, however, does not necessarily constitute a valid argument for not requiring the indemnity — the party best able to control the loss should be the one indemnifying the other party from and against that loss, regardless of whether insurance is available to backstop the indemnity.

**Insurance is a fundamental way to manage Risk** -- If a party has responsibility for a type of loss on a project, it will want to obtain insurance for that loss to minimize its costs, should the loss be realized. Accordingly, when preparing insurance requirements for construction - related contracts, it is important to identify and address the risk obligations associated with each project discipline and to make sure that the limits are adequate to address possible losses.

**Ensuring that Waivers of Subrogation are in place** – Including waivers of subrogation ensures that many project risks are properly transferred from the contracting parties to their insurers. Basically, such provisions prevent insurers from passing risk back to downstream project parties by precluding insurers from seeking reimbursement from other project participants for amounts paid on claims. Because an insurer “stands in the shoes” of its insured when bringing a subrogation claim, it can not bring such a claim if its insured has waived this right in its contract with the allegedly culpable party. For this reason,

waivers of subrogation ensure that transferred project risk stays with the insurers.

### **Don't rely on Certificates of Insurance**

- Many parties to a construction project fail to adequately confirm that the project insurance requirements have been satisfied, either upon execution of the contract or throughout the duration of the project. Required coverage limits, additional insured status and waivers of subrogation provide no benefit if they were not obtained or are permitted to lapse. Owners and contractors frequently rely on a cursory review of certificates of insurance to “confirm” compliance with insurance requirements. This practice is risky, as many insurance certificates include incorrect and / or incomplete information, such as omitting mention of risk-changing exclusions or endorsements. In addition, most certificates of insurance are prepared using an industry - standard form. Courts have found that these forms are so replete with express disclaimers that they are not legally binding on the party providing them. As such, it is advisable to require in the contract not only a certificate of insurance evidencing the proper insurance coverage, additional insured status and waiver of subrogation but also delivery of applicable endorsements (if not the full policies themselves) evidencing such coverage. Performing a diligent review of the information provided will greatly diminish, if not remove, the anguish, costs and lost time suffered upon discovery, after a claim is made, that the coverage identified in the certificate of insurance in fact is not what the actual policies provide and is not what is required under the relevant contract.

**Before signing , have contracts reviewed by a knowledgeable attorney and read contracts for consistency-**

Each construction project includes multiple contracts , all of which should be consistent and complementary . Project lenders' and owners' requirements regarding payment timing and limitations should be properly flowed down into all project contracts so that payment provisions are consistent throughout the contracts . In addition , many lenders, owners and contractors use form contracts with insurance and indemnity requirements that are outdated , unenforceable or otherwise unobtainable . Forcing a party to obtain insurance in a form that is no longer offered , or offered only at a cost-prohibitive premium, is not in the project's best interest. To avoid these problems, it is crucial to have an experienced attorney review the contracts . Just as important, there is no substitute for each party reading its contract very carefully before signing . Beyond the obvious problems of errors and inaccurate information that creep into negotiated contracts , careful review may reveal additional risks , improperly allocated risks and other issues that a lawyer , who often is not as familiar as the client with the project, would not catch.

## 7. CONCLUSION -

As the risk is an inevitable aspect of a construction contract , it is quite important for the project owner to take some important steps to mitigate risk. In this direction , allocation of entire risks of the project among different related parties involved within a construction contract can be understood as an important measure adopted by project owners. It can be concluded that there are a number of

risks embedded with a construction project which are quite necessary to be managed. These risks are having different nature and impact over the contract .Thus there is a need of including a disclaimer within the construction contract which is designed for the purpose of shifting risk from one party to another in the legal manner .

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