

Nominated Subcontractors on International Projects: Approaches to Risk Allocation

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What Is It?

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

What Is It Not?

It is not domestic subcontracting.

A "domestic subcontractor" is one in whose selection and appointment the Employer traditionally plays no part other than simply giving consent when that is required under the terms of the main contract. The appointment of the subcontractor is treated as something entirely for the benefit of MC - a purely "domestic matter."

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

Why Nominate?

Nomination is used because there are benefits for the Employer in using the system. The key benefit for the Employer is control over the choice of, and performance required from, NSC. Above all, the Employer 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. The Employer may have developed a long-term business relationship with NSC. The Employer may wish to use a proprietary system offered by NSC.

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

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

NSC Selection Procedures

A person executing work or supplying goods may be a NSC if the work or supply is the subject of a provisional sum or he is "nominated" or "selected" or "approved" by the Employer or the Engineer.

This means such a person can be a NSC if he is identified in an "agreed" list of proposed subcontractors.

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

Selection Procedures - FIDIC Red Book 4th

In its Conditions of Contract for Works of Civil Engineering Construction (4th ed. 1987) ("Red Book 4th"), FIDIC recognises that the failure of NSC to perform can have serious consequences for both MC and the Employer. 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 MC in respect of NSC's breaches and against the negligence of his workmen and misuse of any Temporary Works.

These rights of veto are crucial, and 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 effect a post-contract nomination may have on MC's programme, and NSC's preparedness to commit to completion of its works on a date that melds with the programme.

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 declines to enter into a subcontract with NSC, the Engineer will have several alternative lines of action open to him. He can:

- Nominate an alternative NSC to whom MC would not object.
- Omit the work that is the subject of the nomination from the main contract and have it carried out by an independent Contractor. There may be claim consequences.
- Seek to negotiate more favourable subcontract terms with NSC.
- 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 FIDIC Clause 51. This also can have claim consequences

Nomination and Objection Process - SIACC

The approach under the Singapore Institute of Architects Articles and Conditions of Contract ("SIACC") is very similar to under the Red Book. The Employer may:

- when the identity of the subcontractor is known at the time of tender, designate a subcontractor in the Specification or other Contract Documents - a "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").

DSC differs from an NSC with regard to payment provisions and objection. There are

more limited rights of objection by MC with regard to a DSC than with regard to an NSC.

There are several grounds for reasonable objection:

- Reasonable grounds for supposing, on the available known facts at the time of the Nominated Instruction, NSC (but not a DSC) has inadequate:
 - financial standing
 - solvency
 - technical competence
 - reliability
- NSC/DSC is not prepared to:
 - accept equivalent responsibilities or obligations consistent with those undertaken by MC; or
 - indemnify MC against liabilities, claims and damages arising from defaults of NSC on the same terms as MC's indemnity to the Employer; or
 - accept liability for reasonable delay damages; or
 - accept 14-day "pay-when-paid" payment terms, subject to retention and set-off or counterclaim.
- NSC is not prepared to accept provisions in the Subcontract allowing default termination for:
 - failure to proceed with due diligence; or
 - failure to remove or replace work, materials or goods.
- NSC insists on an unreasonable exclusion of liability taking account of MC's obligations under the main contract.

SIACC - Architect's Powers

When MC raises a valid objection to NSC, the Architect may:

- Make a further nomination; or
- Instruct MC to carry out or make arrangements for carrying out the work (although 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).

Standard Problems

Selection Process

If MC does not secure a suitable amendment of the provisions of the Red Book 4th 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 Quantities.

The true nature of the NSC Works and its effect on programming often is 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.

The solution to the first problem may involve tailored main contract amendments to the standard form conditions. (Throughout this paper, suggested amendments are displayed in *italics*.) The solution to the second problem involves contractors asking the right questions during the tender phase.

When the NSC will be placed after MC is selected, then Subclause 59.2 provides the necessary veto right. When, however, NSC will be in place before the main contract

tender process, a prudent tenderer will seek full details of the NSC and of the subcontract terms and conditions.

With this information, the prudent MC can consider his attitude to the nomination when there still is room to maneuver.

Selection Process: Red Book 4th - 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 subclause 59.4.

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.

Selection Process: SIACC - Possible Solutions

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 Materials: Red Book 4th

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 is with regard to the design of any materials supplied by NSC. However, this is unclear.

The subcontract must, however, specify that when 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 fulfill such liabilities.

Defects in Works and Materials: SIACC

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

As if the risk allocation was not clear enough, MC also is 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, materials or goods, or in regard to the provision of design services.

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

Defects in Works and Materials: Possible Solutions

If MC cannot secure suitable amendment of these provisions, then the problems MC will encounter are:

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

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 4th 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. 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 the Employer.
- Personal Injury insurance capped no lower than the potential liability of MC arising from design fault.
- Bonds in stipulated form

Modifications could include:

- .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).

- .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 its 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.
- .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.

- .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.
- .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 entitle any insurer to refuse to pay any claim made under the insurances referred to in Clause .1.
- .4 The Subcontractor shall provide 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.

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.
- Reliance where appropriate on the right of reasonable objection.

Delay or Disruption of the Works

Red Book 4th, 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 (3) in regard to Contingency Sums; or
- 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.

If MC cannot 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 costs caused by NSC's acts, defaults and/or breaches of contract.

The Employer 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.

- .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.
- .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

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, SIACC does not require the Architect to replace an insolvent NSC.

It is unclear whether the Red Book 4th requires a re-nomination, and this probably is why we find references to the "named subcontractor." Named subcontractor provisions represent an attempt by Employers 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.

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.

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

- The Employer nominated an NSC for a critical portion of the main contract works.
- The Employer stipulated to MC the terms and conditions of the subcontract. This did not include providing a bond for the benefit of MC. But, the subcontract required the NSC to procure a bond in favour of the Employer.

- MC did not object to NSC and did not independently require NSC to procure a bond in favour of MC.
- NSC defaulted, and as a result, MC was faced with additional costs to complete the Works.
- The Employer called the bond and, pursuant to the main contract conditions, used the funds to contribute to MC's additional cost of completion.
- NSC reimbursed the bonding company and brought a claim against MC for an account of surplus bond monies under English Law.

Insolvency - Possible Solutions: FIDIC

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 fulfill such liabilities, and
- 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 [] per cent of the subcontract price and shall be released on the date of issue of the final certificate under the subcontract.

Insolvency - Possible Solutions: SIACC

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- (2) Provided that the Contractor shall be entitled to object to a Nomination Instruction either:
 - (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:
 - (ix) there is no requirement for the provision to the Contractor of a guarantee or performance bond for the due performance by the Nominated Subcontractor or Supplier, or Designated Subcontractor 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 [] 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 Employers and their consultants.
- 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, offer no special protection to MCs with regard to NSCs. So, every opportunity must be taken to negotiate changes to the standard NSC provisions in the Red Book and SIACC and the corresponding subcontracts.