"Construction and Infrastructure Contracts"

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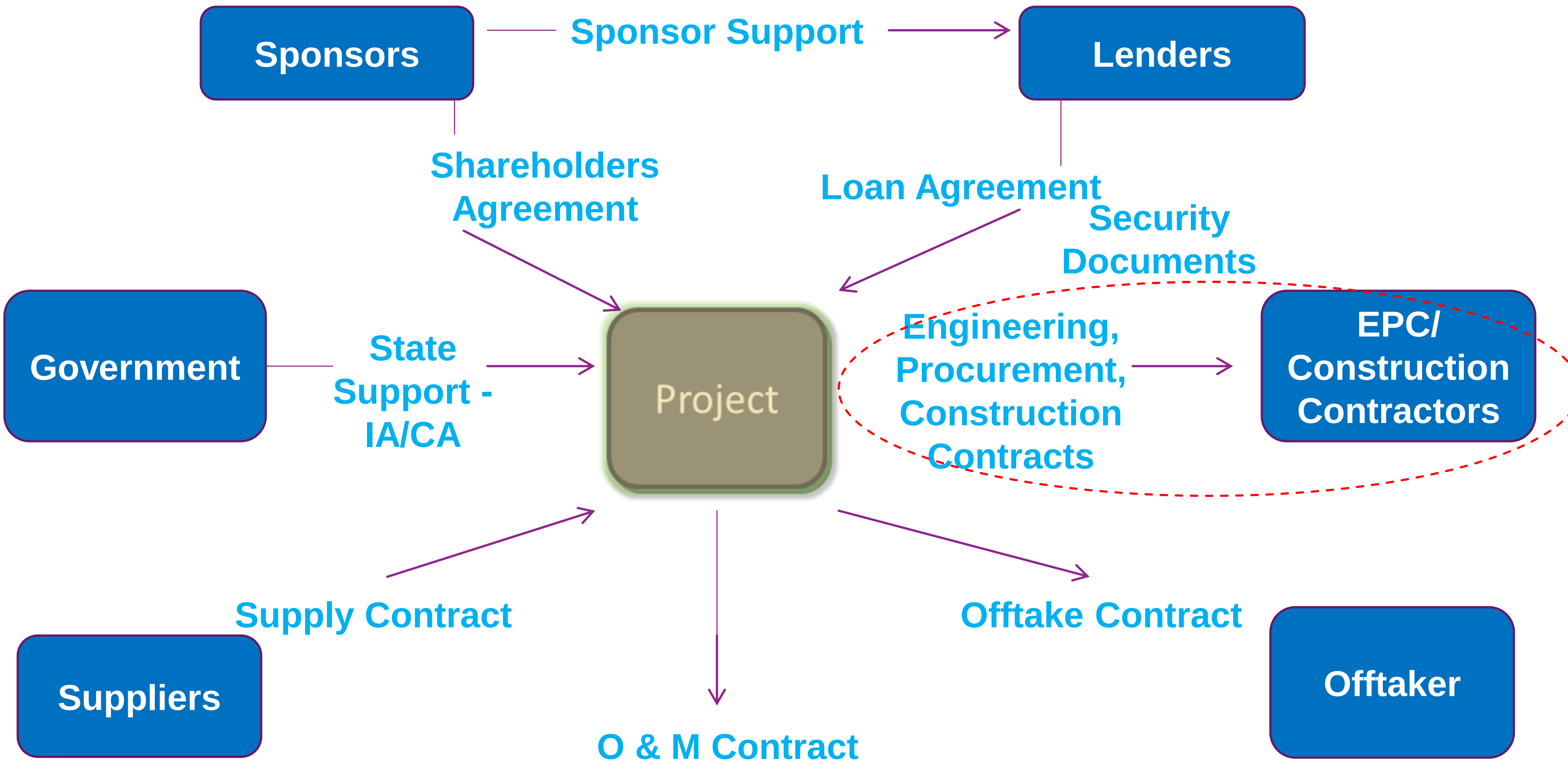
Contractual Matrix in a Infrastructure Project



Key Objectives of the Owner/Employer and the Contractor

Owner's Objectives

- Certainty of costs with limited escalation
- "Back-to back" with project contracts
- Adherence to timelines and time for completion
- Compliance with specifications and warranties
- Pass-through of compliance risk
- Interface with other contractors
- Single point of contact and responsibility
- Performance guarantee

Contractor's Objectives

- Rational allocation of risk
- Pass-through of taxes and other external costs
- Extension of time and increased costs for delay as a result of circumstances beyond the contractor's control or due to acts and omissions of the Owner
- Force Majeure protection
- Timely payment
- Certainty of total outside liability
- Escalation permitted to address volatile market conditions

Key Risks & Risk Allocation

	Risk	Typically borne by	Mitigation
1	Geological/ Soil Conditions/Site Conditions (presence of obstructions, utilities, etc)	Employer	Conducting proper soil testing/geological and site surveys Requiring the Contractor to satisfy itself regarding site conditions
2	Delay in meeting project milestones / scheduled completion date	Contractor (to the extent of LDs) Remainder- Employer	**For Employer –** ▪ liquidated damages ▪ step-in rights of Employer ▪ stringent termination provisions. **For Contractor–** Limitation of liability
3	Loss of material en route	Depending on model of contract CIF/ FOB	Insurance

Key Risks & Risk Allocation (Contd.)

	Risk	Typically borne by	Mitigation	
4	Failure to meet performance standards	Contractor	**For Employer –** ▪ liquidated damages ▪ step-in rights of Employer ▪ stringent rejection/ termination provisions	**For Contractor–** Limitation of liability
5	Defect in design /engineering	Contractor (if design and engineering is within the Contractor's scope and during the defect liability period only)	**For Employer –** Warranties /Indemnity	**For Contractor-** Limitation of liability
6	Construction defect	Contractor (during defects liability period only) Remainder of the project life- Employer	**For Employer** - Long term O&M contract for life of project (after expiry of defects liability period)	**For Contractor–** Limitation of liability

Key Risks & Risk Allocation (Contd.)

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	Risk	Typically borne by	Mitigation	
7	Latent defects	Contractor (heavily negotiated clause)	**For Employer** - Warranties / indemnity	**For Contractor–** Limitation of liability
8	Increase/decrease in scope of work	Employer	Detailed ‘variation’ or ‘change order’ provision	
9	Manpower- accidents	Under labour laws - the liability on the Employer Contractually – Liability typically passed on to the Contractor	Insurance	

Frustration

- Section 56 of the Indian Contract Act deals with the Doctrine of Frustration.
- Aimed at dealing with events that events **so fundamental** as to be regarded by the law to strike at the root of the agreement.
- Consequence of 'Frustration': **Parties are discharged from performing the contract**.
- Difference with FM:
  - Frustration-parties discharged
  - FM usually leads to suspension.
- **FM is a legitimate exit route contractually agreed between parties. Frustration is a statutory remedy**
  - The FM clause will typically entitle one or both parties to suspend performance or to seek an extension of time for performance.
  - Unlike frustration, a FM event will not always bring a contract to an end if the FM clause provides otherwise.

Force Majeure (FM)

FM is usually a **contractually defined term**.

<u>Typical Exclusions</u>:

- Payment default and economic hardship
- Inability owing to export restrictions to obtain goods at contract price
- Events which increase the cost of performance of contract
- Strikes & lock-outs restricted to contractor/sub-contractor

<u>Typical Inclusions</u>:

- Act of God, war, inundation, epidemics, riots, civil commotion
- Adverse natural calamities
- Any other happening which the affected party could not prevent or control.

<u>Typical consequences</u>

- Extension of Time <u>(Effects of FM v. FM itself)</u>
- Suspension of obligations
- Termination – Extended FM

Suspension

- **Suspension is a contractual right and not a statutory concept**
- Typically suspension rights accrue to:
  - the Employer in case of emergencies, national security (DBFOT contract – design issues?)
  - to Contractor in case of non-payment

- Obligations of the parties continue during suspension since contract is not terminated
- Consequences of Suspension- Extension of Time and Increased Costs

Termination

- A termination clause in a contract usually is of two types: (i) For convenience; and (ii) For cause or on default.

- **Termination for convenience:**
  - Termination "at will" or "for convenience": allows one party to terminate without having to establish that some event has occurred or breach has been committed by the other party

  - It can be useful if the contractor finds the project will be unprofitable or too risky, or the project has been suspended for a significant period with no prospect of it being recommenced

- **Termination for Cause:** Typically for non-payment, material breach like violation of representations/warranties

- Owner's Right to Terminate is usually wider
  - Failure to meet the time for completion
  - Underperformance
  - Aggregate limits of LDs having been exhausted

- Other typical termination events
  - Insolvency
  - Prolonged FM

Change in Law

Key Elements

Definition of Change in Law: Scope, relevant cut-off date, etc.

Conditions for claiming Change in Law relief: **Notification** requirements, any **materiality thresholds**, etc.

Consequences and relief for Change in Law: **cost Increase/decrease**, consequences **other than cost** implications

- Typically, Contractors obligated to comply with all applicable laws.
- Possible Changes in laws cannot be foreseen in long-term contracts.
- **Defining 'Change in Law'**
  - Important to draft this in a manner reflecting the commercial understanding
  - Generally, Change in Law encompasses coming into effect of new law, amendment/repeals etc. of existing laws, change in interpretation or application of law, which occur after a certain date.
  - Cut-off date for Change in Law.
- **Issues apropos coverage of 'Change in Law'**
  - Cover only laws of India?
  - How is 'law' being construed for purposes of Change in Law relief?
  - Any exclusions from the ambit of Change in Law? For example, some contracts provide that Change in Law includes change in tax except change in income tax.
  - Applicability of Change in Laws at what levels?

Separate Contracts v. Single Contracts – Tax Rationale

Why splitting is important from a tax perspective?

Complex tax regime and reliance on contract documents to ascertain the tax treatment

- **Separate tax for goods & services**
  - Multiple laws
  - Double taxation due to overlap, such as composite supplies, intangibles etc.
- **Central vs. State structure**
  - Different authorities
  - Various exemptions/ concessions
- **Indian Jurisprudence**
  - Prolonged litigation
  - Conflicting judgments
  - Evolving laws

Separate Contracts v. Single Contracts – Tax Rationale

Possibility of tax benefits being challenged by authorities:

- –VAT on imports/ inter-state supplies
- –Cenvat credit denial by treating entire contract as 'works contract' for building/ civil structure

Challenges around valuation for VAT/ Service tax/ Labor or Building cess

Composition scheme under VAT/ Service tax could extend to entire contract value

Classification issues for services covered under reverse charge (could also lead to denial of credits)

Uncertainty around withholding VAT

While above challenges can be mitigated to an extent through appropriate structuring of the single-turnkey contract, having independent contracts for different activities often proves to be more beneficial from tax perspective

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