

INTRODUCTION CONTRACT MANAGEMENT

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LECTURE NOTES

INTRODUCTION TO CONTRACT MANAGEMENT

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1. INTRODUCTION

In daily life many legal relations are established to arrange social action. Most probably no legal relation is utilised more often than the contract. Many contracts are established without people being aware of that. If for instance you decide to do some

shopping and you return with 23 items, some 23 contracts have been established in the mean time, but probably more. If on the way, you meet a friend and decide to drink a cup of coffee, one contract more comes in to existence, provided that you do not also go for piece of cake (or two).

Contracts may cover simple social relations like purchasing or renting goods, or arranging services, but also very complex relations may result from the establishment of contracts. In water resources management nowadays many works and services are contracted out through sometimes series of complex, multiple party contracts. The decision of a government to delegate the construction, the operation and maintenance function of the urban water supply to the private sector, may require a dozen of contracts, each with many actors involved.

In this introduction we will first concentrate on the answering of a few basic questions:

- What is a contract?
- How are contracts established?
- How are contracts ending, being ended or terminated?
- What grounds lead to termination of contract?
- Which may be the consequences of termination of contract?
- Which special legal arrangements may be useful to facilitate contract management?

We depart from Roman Dutch and Common (Civil) Law systems, but where needed, we will make some comparison with other legal systems.

2. AGREEMENT AND ESTABLISHMENT OF CONTRACT

A workable definition (for our purpose) of contract would be the following. A contract is:

A mutually agreed legal relation (i) between two or more capable and competent persons or parties (ii) to exchange goods, efforts or services (iii) at a certain moment of time or over a certain period of time (iv).

So a contract is a relation, not an action! Prior to the existence of a contract there is the action of the (mutual) agreement. A (mutual) agreement is the (legal) action to establish a mutual relation aiming at the creation of legal consequences. Once this is done, a contract comes in to existence. So, there is no need to put a contract in to a written form, unless the law prescribes. Of course, for the purpose of alleviating the burden of proof it is advisable to put contracts of any substance in to writing. The opposite situation also occurs. Many written documents are presented as contracts, but in fact they are missing one or more of the requirements that constitute contracts.

Now let us consider these 4 elements that constitute a legally binding contract:

Mutual agreement (i) is reached when the will to establish the legal relation has been mutually expressed. Since we are considering a mutual relation the will has to be interconnected. Moreover, the expression of will should be valid. In 4 cases the expression of will is certainly not valid:

- In case of threat
- In case of deception
- In case of abuse of circumstances
- In case of error.

Especially the case of error can become very complex and a lot of jurisprudence developed (under many different legal systems). The crux of the matter is that agreement is reached when one of the parties may reasonably trust that the other party was expressing his will correctly. This principle of protection of the aroused trust is coming back in many positions in civil law.

Case 1

A student negotiates with a potential landlord about the renting of a room. The landlord shows the student various rooms. Both of them agree in the lease of a room. The student pays the deposit and the first installment of the house rent. Later on, it becomes painfully evident that the student had a room in mind on the first floor and the landlord another one on the ground floor.

Do they have a legally binding contract? Why or why not?

Upon payment of the deposit, the landlord says: "For the same price you can also use the piano, that is in the room." The student agrees.

Do they now have a legally binding contract? For which room?

A second condition for the establishment of legally binding contracts is that agreement has to be reached between at least two capable and competent persons and parties. Again it is not so easy to identify which persons or parties are capable and competent. The law can give us some guidance. Two types of persons are certainly not capable: minors and insane people. Again, also for actions conducted by these categories of persons the principle of trust comes in. If the other party may reasonably trust that the person whom he is dealing with is capable to enter in to agreement, the agreement may under certain conditions still be valid.

Case 2

A beautiful lady who has the appearance of an international model (high-heeled shoes, expensive clothes) buys a fur coat of 5000 US \$ in a shop. She opens her fancy purse (also worth a lot of money) and pays cash. Five days later an elderly man is returning the fur coat (with some damage). He wants the money back that was taken from him and paid by his daughter, age 16 and legally not capable in entering in those kind of agreements. The shopkeeper refuses to take the coat back. Can the father rightfully claim his money back? Why or why not?

The question about competency is more complex. We are nearly always dealing with capable persons who are not authorised to conduct certain actions because of the special position they are holding e.g.:

- A notary is not authorised to buy the house that has been commissioned to him.
- A judge cannot buy a house of which the ownership is under litigation at his own Court.

The third condition deals with the object of a contract. Any contract should be aiming at exchanging goods, efforts or services. This may seem simple (one buys a good for a certain price), but delivers a serious source of contention in practice. Most legal systems (Roman-Dutch, Common (Civil) Law) are ruled by the principle of Freedom of Contract. The contract partners may put the contract in any desired form. Further, any good, service or effort may be subject to contracting, but within the restrictions of the law, public order or good morals. It is for instance not allowed to sell your child. Legal restrictions as imposed by the law are often clear. If they are not clear, there is always the independent Judiciary to rule about the explanation of the law. However, to give an interpretation of a restriction by or a conflict with public order or good morals is more complex and may differ substantially from culture to culture. To

acquire payment for a marriage of your children is in a western culture not acceptable.

In another culture, this might be slightly different and there might be very good reasons for that. (So, one could say that not only laws differ from country but certainly also aspects of public order and good morals.)

The fourth condition speaks for itself. A contract will always be subjected to a time indication or at least to a notion of time. Even when the period in which effort has to be done is indefinite, still one can say that there is a time indication. Basically any time frame for the exchange of goods, services or efforts may be chosen.

Special cases are when contractual obligations are linked up with conditions or events that have to take place in future. These conditions or events then determine the time path in which things have to take place.

Two different cases can be identified:

- Suspending condition
- Dissolving condition.

In case of a suspending condition a contract is only valid, as and when the event that fulfils the condition takes place: e.g. a student is offered a job, under condition of graduation. Only at the moment of graduation the job is hers/his.

In case of a dissolving condition the contract is valid until such time that a certain event takes place: e.g. the student gets the job right away, but will loose it when he or she does not graduate. That makes a difference. In the last case there is a fully-fledged contract with all the legal consequences.

Another situation occurs when a contract is established in retrospect. For example: somebody has been working for a company as a daily paid worker. A contract is signed that he is now a fixed employee for an indefinite period of time and that the period in which he was working as a daily paid worked is considered to have been part of the contract. This has substantial advantages for the employee (pension etc).

Suspending condition:

No contract ----- Event-----Contract

Dissolving condition:

Contract-----Event-----No contract

Retroactive:

No contract-----Event

Contract

3. FREEDOM OF CONTRACT VERSUS FORMAL REQUIREMENTS

Most of the legal systems we are dealing with (Roman-Dutch, Common (Civil) Law) here are characterised by the Principle of Freedom of Contract: The contract partners may put the contract in any desired form. Further, any good, service or effort may be subject to contracting. This principle, however, is never absolute. We already saw that a contractual relation may not be contravening law, public order or good morals.

Case 3

Dr. Jekyll borrows 100,000 pounds from Mr. Hyde, his neighbor. In good neighborliness they agree that Dr. Jekyll will pay back this sum of money within 6 months of time. They also agree that when Dr. Jekyll does not keep to his obligation, Jennifer, the daughter of Dr. Jekyll, will join Mr. Hyde in his mansion to live with him until he or she dies. In that case the borrowed sum is to be considered a gift. Dr.

Jekyll appears to be a notorious gambler, who frequents all the casinos in London. After 6 months he has to inform Mr. Hyde that he will not be able to pay back the indebted money.

Dr. Jekyll and Mr. Hyde both request Jennifer to move to the house of Mr. Hyde to spend the rest of his or her life in the company of the latter, elder gentleman. Jennifer agrees! The house of Mr. Hyde is much nicer and bigger than the one of her father and for the first time of her life, she has a whole wing for herself. On top of that, she does not dislike the company of Mr. Hyde. Jennifer lives a life of leisure, because no effort or whatsoever is requested from her!

But after a few months, Jennifer gets bored. She leaves the house of Mr. Hyde to join a teenage music group. The teenage music group is not interested in her vocal qualities. Heavily frustrated, Jennifer marries a famous soccer player.

How many legally valid contracts are established under Roman-Dutch or Common Civil Law in the true story of above?

Is Mr. Hyde entitled to a reimbursement of his money?

Should he take legal action?

The law is normally giving some binding requirements that cannot be overruled or that always have to be included in a certain type of contract. In those cases variations are not allowed.

Certain contract elements or complete contracts can only be established when certain formal requirements are followed: the transfer of a house or other immobile good can only take place by Notary Deed.

The law can also give some instructions that may be binding unless the contract partners explicitly declare that they want to make a different arrangement e.g. clauses of exoneration. Bus companies normally exclude liability for any loss of damage to personal belongings during the bus trip. If the client is not made aware of this, under circumstances the bus company might be liable.

The question on whether certain rules are directly binding or advisory is either explained in the law or interpreted by the court.

4. INVALIDITY OF CONTRACT

Apart from the normal expiration of a contract (service completed, goods delivered, compensation paid) there are various other ways in which a contract can either not start, or end or being ended. The most important ones are the following:

- The contract can be null and void (from the onset!) because the delivery of the service, goods or effort is against the law, public order or good morals.
- The contract can be nullified because of defects in will, incapability, incompetence. In this case one of contract partners has to take action, though.

So, basically it means that a legal relation who was believed to be in existence is actually not in existence or is declared not to have been in existence.

One has to make a distinction between these cases and the cases in which a contract is simply not being established, because of the inability to identify the object of contract.

Case 4

Mister Sinatra, a famous pop star, is entering in to agreement with Mister Capone that he will sell his soul to the Devil for the price of 100,000 American dollars. If Mr. Sinatra will not do whatever the Devil may request him, Mr. Capone is allowed to take a kilo of the flesh of Mr. Sinatra's belly. The flesh will then be sold in small units to the fans of Mr. Sinatra, to earn back the money and the interest.

Is a legally binding contract established? Why or why not?

The legal consequences of a contract not coming in to existence or being nullified are the same. Retroactively, the contract is considered never to have been in existence!

5. TERMINATION OF CONTRACT

Termination of contract is a phenomenon that differs completely from invalidity, or non-existence of contract. There is some similarity with nullification. As the word already indicates we are dealing here with an action. In the case of breach (or violation) of contract, one of the most important grounds for termination, the contract exist until such time that it is legally terminated. (A contract may also be partly terminated or partly continued.) So, the difference with the cases in the former paragraph is that termination always encompasses a legal action. Moreover, the part of the contract carried out before the termination may be valid (,unless the court declares the contract invalid from the beginning).

Breach (or violation) of contract

In the case of breach of contract some of the obligations resulting from the contract are not or insufficiently delivered.

Grounds for breach of contract may be manifold. Goods might not have been delivered. Goods, services or efforts might not be good enough nor up to the agreed standard. There might be aspects of exceeding of time. In the special case study many different causes leading to breach of contract are presented and discussed.

The legal consequences of breach of contract again can be manifold:

- The defaulter may be forced or may be forced again to deliver the goods, services or efforts up to the right standard.
Breach of contract nearly always leads to a right for the complainant to retain compensation of his part of the contract to the defaulter.
- The contract may be (partly) dissolved on request of the contract partner who is not at fault. No (or restricted) exchange of goods, services or efforts takes place.
- The defaulter may be charged to damages. This action may be combined with one of the former ones. But in this case no or insufficient delivery only is not enough. There has to be an element of culpable negligence. So, at least one of the contract partners is willingly, knowingly neglecting or not taking sufficient care of a main issue described in the contract (mainly in relation to the envisaged work, service or effort). The defaulter should be blameworthy. And also there has to be identifiable damage and that damage should be directly related to the behavior of the defaulter.

Other termination grounds

Breach of contract is not the only ground for termination. There are other circumstances in which the termination of a contract may be requested e.g:

- One of the contract partners passes away and the service can only be delivered personally;
- One of the contract partners is declared bankrupt;
- The service cannot be delivered because of force majeure: war outbreak, floods, bad weather etc.

Again, until certain termination grounds come in to existence, the contract elements that have been handled before such time may be valid. (However, the Court may decide to dissolve a contract in its entirety in retrospect).

In case of contract termination the burden of proof is with the complainant. Termination of contract is always preceded by a notification of default (in writing) to the defaulter. The defaulter gets the opportunity of redressing his contract violation.

Case 5

Mr. Harun El Posa, a notoriously rich oil sjeikh, organises a party in his house for his international business friends. Mr. El Posa gets very drunk. As a Moslem he is not used to drink alcohol. One of his American business friends offers to repaint the unique Rembrandt van Rijn painting (owned by Mr. El Posa) with a value of 50 million US dollars. The American will recreate the Rembrandt for the price of one beer only. Mr. El Posa agrees.

Has a legally binding contract been established? Why or why not?

The American finishes the job. He recreates the invaluable Rembrandt by covering the painting completely with his home tomato ketchup, that he carries along all over the world in his suitcase.

The day after, Mr. El Posa realises the enormous loss. He sues the American for damages. The American reacts by stating that he simply fulfilled a contractual obligation. Will Mr El Posa succeed in his claim for damages?

Mr. El Posa who still owns the unique Rembrandt addresses to the famous painting restorer Van Meegeren and both agree that Mr. Van Meegeren will restore the Rembrandt painting for the price of 1 million dollars. After a month Mr. Van Meegeren has completed the job. Mr. El Posa admits that Mr. Van Meegeren has done an excellent job and he claims his painting back.

Can Mr. Van Meegeren retain the painting until Mr. El Posa has paid the price for the job well done?

Imagine another case where Mr. Van Meegeren uses the wrong chemical thinner and everything, what Rembrandt painted, disappears from the painting?

Can Mr El Posa claim fulfilment of the contract?

Can Mr. El Posa claim damages?

Imagine yet another case where Mr. Van Meegerens' servant spoils the painting. Mr El Posa claims damages. Can Mr. Van Meegeren object that he is not responsible for his servant? What, if the servant had been seconded to him by Mr. El Posa for this specific job? What if the servant had been seconded to him earlier by Mr. El Posa for any job or whatsoever?

Imagine yet another case where Mr. El Posa puts the chemicals to do the job at the disposal of Mr. Van Meegeren. The chemical, a solvent, appears to be completely inappropriate and the painting gets spoiled. Can Mr. Van Meegeren object that he is not blameworthy?

Can Mr. Van Meegeren exonerate himself in advance by stating that he cannot be held responsible for the result of the restoration?

6. STANDARD CONDITIONS OF CONTRACT

It is not always practical to negotiate about everything over and again for contracts or items that are generally or repeatedly used. Certain contracts or contract elements might be handled by Standard Conditions of Contract, which are developed through a lawful institution. The binding of Standard Conditions of Contract, however is often (nearly always) voluntary. Many sectors or professional associations have produced their own Standard Conditions of Contract which have been declared valid through the competent authority or even by or through the law or regulation.

A common pattern is that one of the contract partners e.g. the Government might refer to Standard Conditions of Contract when negotiating with the private sector. The Government of Zimbabwe when contracting out works of civil engineering construction is nearly always referring to the General Conditions of Contract for Civil Engineering Works as provided by and from time to time revised by various sector associations (engineering institutions and contractors associations).

This has the big advantage that there is no need to negotiate in detail over contractual issues which might always be very similar. The disadvantage, of course, is that the Freedom of Contract is somehow restricted.

Naturally, Standard Conditions of Contract are continuously under surveillance by the Judiciary and should themselves not be contravening law, public order or good morals.

Some of these Standard Conditions of Contract are aiming at international binding whether or not as a consequence of international tender procedures (e.g. World Bank, FIDIC). Annex 1 gives an example of the items that could/should be covered by Standard Conditions of Contract. A discussion of these items is presented. A case study on a multiple party contract for the constructing of civil works is presented in Annex 2.

ANNEX 1: STANDARD CONDITIONS OF CONTRACT ITEMS TO BE HANDLED (CONSTRUCTION CONTRACT)

1. PRE-CONTRACT

- 1.1. Contract preparation: conditions of contract, design and technical specifications, Bill of Quantities (all elements should be part of the contract), Schedule of Fares and Fees, geological reports etc.
- 1.2. Preparation of Tender Document
- 1.3. Initiation and publication of tender
- 1.4. Inspection of site/works with interested contractors (explanation of required services/TOR to consultants).
- 1.5. Collection of bids
- 1.6. Qualification and short-listing of suitable contractors on predetermined criteria e.g.:
 - **experience**
 - **performance in similar contracts**
 - **availability of resources: plant, personnel, finances**
 - **financial capacity, sureties, insurance bonds**
 - **legal record (no blacklisting, no criminal records).**
- 1.7. Advise to Tender Board
- 1.8. Contract awarding
- 1.9. Notification of Acceptance (by letter)
- 1.10. Commencement of works

Box A

During a negotiation period potential contract partners are in principle free to come to an agreement or not. The rule is that basically both partners can decide not to enter into agreement until the mutual expression of the will has taken place. However, the invitation to enter in to negotiation can under circumstances lead to an obligation to compensate costs and even to pay damages, especially when large investments are done in the negotiation phase and when the investor could thrust that an agreement to carry out the contract would be reached.

Case 6

Contractor Poolcare has been pre-selected by the authorised municipal committee with 2 other contractors to put in a bid for the construction of a new municipal swimming pool. After scrutiny of the three bids Poolcare is requested by the chairman of the committee to extend his bid for the performance of additional services. Poolcare consults an architect and seeks professional advice for heating and electricity, in fact items that pertain to the requested extensions.

Poolcare is notified by the committee that his bid is the lowest and that it will be accepted after a few minor improvements. However, the City Council still has to approve the bid.

The unexpected happens. The City Council rejects the bid of Poolcare in favor of the bid of Swimming Pleasure, a bid that came in late, but which appeared to be much cheaper.

Poolcare addresses the Court (Roman Dutch system) and claims establishment of the contract through acceptance of the bid and subsidiary payment of damages. How should the Court rule to your opinion?

- a) The municipality is not allowed to break off the negotiations. The negotiations should be continued and should result in a fully fledged contract. All costs should be covered, because Poolcare could thrust that an agreement would be reached.
- b) The municipality is allowed to break off the negotiations, but costs should be compensated.
- c) The same as under b, but also the deprived profits should be compensated.
- d) The municipality is allowed to break off the negotiations. No agreement on the establishment of a contract has been reached because the will of the municipality has not been formally expressed. No compensation for costs is due.

2. CONDITIONS OF CONTRACT

- 2.1. Applicable law and jurisdiction
- 2.2. Standard Conditions of Contract (e.g. FIDIC)
- 2.3. Determination of beginning of contract period and commencement of works:
 - a predetermined period after Letter of Acceptance of Contractor.
- 2.4. Indication of involved contract parties and third parties or persons:
 - Client/Employer
 - Engineer/Consultant
 - Contractor/Subcontractor
- 2.5. Rules for subcontracting
 - nominated subcontractors
 - (pre)qualification
 - rate (sub)contracts
- 2.6. Extent, completion time
 - Contract period
 - extension of time
 - penalty clauses for delays in non-completion
- 2.7. Contract sum
- 2.8. Alterations, additions and omissions
 - by Employer or Engineer (by quotation of Contractor)
 - by Contractor
- 2.9. Variations in a construction contract:: Changes in volume of work (increase or decrease) that will lead to subsequent changes of Contract Sum. Normal variations: increase or decrease of work on items described in the Bill of Quantities.
- 2.10. Other permissible Variations:
 - mutually agreed by the Contract parties

- due to circumstances or external events that can reasonably not be foreseen by an experienced Contractor or Engineer and that normally qualify for a change in price:
 - e.g. weather and artificial conditions
 - changes in legislation or Government policy etc.
- 2.11. Price changes
 - fixed contingencies
 - Price Adjustment Factor
 - permissible variations
 - proven price changes not reasonably to be expected by an experienced Contractor
 - changes in legislation or Government policy
 - changes in official tariffs not reasonably to be foreseen
 - etc.
- 2.12. Payment procedures
 - periods/deadlines
 - interests
 - justified price increases and/or contingencies.
- 2.13. Nature and quality of works and services
- 2.14. Insurance of all kinds
 - sureties and (insured) performance bonds
 - insurance of the works
 - insurance of people at or around the works
 - third party insurance.
- 2.15. Quality control mechanisms
 - sampling methods
 - standards for testing
 - authorized persons etc.
- 2.16. Special risks
 - war
 - state of emergency
 - force majeure
- 2.17. Settlement of disputes
 - mediation: Engineer/Consultant
 - arbitration
 - Court
- 2.18. Communication
 - fixed meetings
 - reporting
- 2.19. Certification of completion
- 2.20. Termination
 - slow progress
 - quality defects
 - bankruptcy, financial incapacities
- 2.21. Special arrangements
 - deviations of Standard Conditions of Contract
 - deviations of normal practices or customs

3. IMPLEMENTATION OF CONSTRUCTION CONTRACT (by Employer or Engineer)

- 3.1. Check compliance with Conditions of Contract
- 3.2. Advance Payments
- 3.3. **Inspection of available resources: personnel, plant, infrastructure**

(disqualification)

- 3.4. Site establishment
- 3.5. Inspection of work done: quantities, quality
- 3.6. Appraisal of progress
- 3.7. Regular communications
- 3.8. Issue of payment on Certificate prepared by Contractor and checked by Employer/Engineer
- 3.9. Appraisal of variations
- 3.10. Price increases
- 3.11. Extension of completion time
- 3.12. Application of penalty clauses for delay
- 3.13. Determination of completion (by Certificate)

4. POST-CONTRACT

- 4.1. Maintenance period**
- 4.2. Payment of retention**

**ANNEX 2: INTRODUCTION CONTRACT MANAGEMENT:
CASE STUDY**

INSTRUCTION

Please, read the text of the case several times and then afterwards try to answer the questions. If you cannot answer the questions, go back to the text to find the relevant information. Bear in mind that a few questions cannot really be answered with certainty, because the contract is not giving sufficient detail. Especially these questions will be subject of arbitration in the Arbitration Game that will be played after answering the questions. The game cannot be played without answering the questions first.

The case is deducted from real data. It was simplified by only omitting insurance companies as parties in the game.

Do not spend more than 2 hours on the reading and the answering of the questions.

THE CASE

1. BACKGROUND

An outbreak of cholera prompted the Development Bank to provide the Town Council of Roughdale in the country X with a loan of 5 million US dollars to improve and extend its deficient water supply system. The loan was initially disbursed to the Ministry of Local Government and has to be paid back, interest-free. Because of the gravity of the situation, the Ministry of Local Government decided to disburse the funds (in total) directly to the Town Council Account of Roughdale in local currency (palu). According to the rules of the Development Bank any loan has to be contracted out and tendered according to internationally approved tender procedures.

In line with normal government practice the Town Council (the Client) requested the Office of the Provincial Water Engineer (the Engineer) to supervise the design, tender and construction procedures. The Development Bank engaged an external

Accountant to supervise the transaction financially and to maintain the rules of the Bank. The Engineer has unrestricted access to the budget: 10 million palu, but ultimately needs approval of the Bank's Accountant for his Final Financial Statement.

At 1/9/1998 the Tender Board awarded the Contract to construct a water treatment plant in Roughdale to a company, named Hydro. Hydro, the company with the lowest bid, was short-listed by the Office of the Provincial Water Engineer on strong recommendation of its direct superior, the Director of Water Resources of the country. Hydro had only registered 6 months before as a company in the Register of the Chamber of Commerce. There are no records of the performances of this company so far. It is not a secret that the Provincial Water Engineer did not like the idea of short-listing this company, but he has a good relationship with his superiors and is the Boss not always right?

2. THE CONTRACT

GENERAL

In a Memorandum of Understanding between the Development Bank, the Engineer and the Client, the General Conditions of Contract (see above) are declared applicable as far as not specified otherwise in the special clauses of the Contract.

The Contract further stipulates that Design and Bill of Quantities are an integrated part of the Contract.

In case of continuous insufficient progress or absence of progress for a period of at least one month, the Contractor can be unilaterally disqualified with a notice period of one month.

Subcontracting has to be approved by the Engineer.

The Contractor should request Variations other than from volumes of work as expressed in the Bill of Quantities to the Engineer in writing.

FINANCIAL

a) The Contract is awarded to Hydro and the total contract sum is the equivalent of 5 million USD in this case 10 million palu. All payments are to be done in local currency (exchange rate 1/9/1998: 1 USD=2 palu). In this country only national Government agencies are allowed to hold foreign currency accounts.

b) Payments are to be done within 30 days after the approval of a Payment Certificate by the Engineer or the Engineer's Representative. (Payment) Certificates are to be sent in by the Contractor within 10 days after approval.

c) No other price increases will be allowed except normal monetary price inflation. A Price Increase Factor is allowed in line with the devaluation of the palu. No further interests are to be charged.

d) No Variations, other than from quantities of work as expressed in the Bill of Quantities will be entertained, and other than that can reasonably be foreseen by an experienced Contractor.

e) There is a penalty clause of 0.2 % of the Contract Sum for every day of delay in completion of the works caused by the Contractor. No price increases will be entertained over any period of delay.

f) Advance Payments shall comprise not more than 20% of the Contract Sum and will be deducted from each Payment Certificate for work done. Advance Payments will be done not later than 14 days after reception of the Letter of Acceptance.

EXTENT

a) The Contract will commence 30 days after the Contractor's Letter of Acceptance has been received by the Engineer. The total contract period will be no longer than 12 months.

RETENTION

Of the total Contract Sum 5% may be retained on the last Certificate to a maximum of 6 months after completion to monitor the quality and the behaviour of the works.

ARBITRATION

In case of severe misunderstandings that cannot be solved by mediation between the Contractor, Engineer or Client, the matter will be addressed to IHE Delft for arbitration.

3. COURSE OF EVENTS

During the Tender Procedure the Engineer shows the site of the works with his peculiarities and there is thorough explanation of the required design and construction features.

The newly founded, indigenous, construction company Hydro qualified on the criteria of the lowest price: 10 million palu and the Tender Board did not hesitate to follow the Engineer's recommendation.

Only 5 days after having received the company's Letter of Acceptance (dated 5/9/1998) the Engineer receives another letter requesting for approval of subcontracting the whole contract to Aqua, another emergent company. (Hydro appears to be a briefcase-contractor with no capacity at all).

The Engineer's Representative inspects plant and interviews personnel assigned to this job. His advice is to only partially approve the subcontracting. According to him it is better to employ another subcontractor, Digby, for the total earth movement work and site establishment (20% of the total work) and Aqua for the rest. Aqua is lacking plant to carry out this kind of work. Digby, a multinational company, has an excellent record in earthmoving and is the normal "house" firm for the Ministry through a system of negotiated contracting. After elaborate financial negotiation and having overcome many problems, all parties agree to this settlement. Digby accepts to do the earth movement for one million USD (20% of the total work).

Aqua signs a subcontract with Hydro to carry out the rest of the works for 60% of the Contract Sum. Hydro will retain the rest of the contract sum (1 million USD) for overhead and administration. Aqua negotiates an Advance Payment of 1 million palu (to be deducted proportionally from the first Payment Certificate) and prompt payment of invoices according to normal practices and customs. As main Contractor Hydro remains responsible for all payments and other financial matters.

So, Digby moves on site at 1/12/1998, long after the planned date of 5/10/1998 and starts carrying out the work.

In the mean time the rainy season has commenced in time and Digby's progress is heavily hampered by the rains. El Nino is lashing country X with the severest rains of the century. Digby does not really start the work and can only wait until the month of April, when clear skies are back again and till the water has percolated in the clay soils of the construction site. In the geological report the site was indicated as not being sensitive to flooding.

From April 1999 onwards, Digby is making excellent progress until contrary to the geological reports, available for consultation in the Engineer's Office, it appears that a big boulder is blocking the site, right at the location of the clear water reservoir. The geological report was prepared under the authority of the Engineer.

Digby is specialist in soft excavation and cannot handle this kind of problem and after consent of the Engineer's Representative on site, it is decided to hire the company Dynam, a foreign company, to remove the boulder by blasting with dynamite. Hydro, who has no representative on site at that time is informed of this initiative. Extensive blasting is needed and some more delay is incurred.

Together with the Engineer's Representative the value of the work done by Dynam is established at 0.5 million USD (1,5 million palu). A Certificate is drafted and approved on 15/5/1999. It is send to Hydro for acceptance and submission. Hydro refuses to accept and to submit the Payment Certificate for Dynam, because the company did not approve the subcontracting of this extra work. At the time this all took place, Hydro did not have a representative on site. Apparently the Director of Hydro is afraid that this expense has to be covered under his Contract Sum.

Digby completes the earth works on 1/6/1998. At that same date his proposed Certificate for Payment is approved by the Engineer's Representative.

Only on the first of July, 9 months after awarding of the contract Aqua moves to site to start the actual construction of the treatment plant. Aqua is making good progress in the beginning, but has to stop the work after about 2 months, because of lack of funds with a total of 40% of the original work done (including earth movement and site establishment done by Digby). After an initial advance payment (of 1 million palu), Hydro has not been paying Aqua anymore. Aqua unilaterally suspends its contract with Hydro in writing on 25/9/1999 because of insufficient payment, indeed a cause for breaking a contract.

During 2 months Hydro scans the market for engaging another Subcontractor, but nobody accepts the offer. The poor financial position of Hydro is well known. Hydro has not paid the invoices of Digby and Dynam as well and the news of Hydro's financial incapacity has spread around.

The Engineer notifies Hydro that the Contract has expired and that penalty clauses are applicable as from 5/10/1999. The Provincial Water Engineer sends a letter to Hydro by registered mail with the following content:

1. The contract period has expired. Penalty clauses are applicable as from 5/10/1999.
2. The Contractor is given the opportunity of completing the works within 1 month from acceptance of the letter.

On 5/11/1999 the Engineer's Representative notifies his Employer that there has been no progress on site since the past two months. The Engineer repeats the disqualification procedure.

On 10/12/1998 the Director of Hydro receives a letter by registered mail sent by the Engineer with the following content:

1. Because of exceeding of time and absolute lack of progress the Government of country X hereby unilaterally ends the contract.
2. Since you have only completed 40% of the work, you are requested to repay the sum of million 1.8 million palu, which was unduly received as Advance Payment and on top of that 1 month of penalty: 60.000 palu.
3. The obligation to pay the Subcontractors will remain with you.

Aqua starts a procedure to sue Hydro because of lack of payment.

Digby and Dynam, who still have not been paid, indicate that they are preparing a Court Action against both Hydro and the Engineer.

Hydro has prepared a Court Action against the Engineer for continuation of the Contract.

In Court all parties agree before any settlement of the Judiciary to first refer this case to the Arbitration Board of IHE to see if the matter can be settled out of Court. The Board now has to give an advice using the following basic data.

4. CALENDAR OF EVENTS AND SUMMARY OF KEY DATA

1. Exchange rates: 1/9/1998: 1 USD = 2 palu
1/1/1999: 1 USD = 3 palu
1/12/1999: 1 USD = 5 palu
2. You may assume that price inflation follows the devaluation of the palu.
3. 1/9/1998: Contract awarding to Hydro (10 million palu).
4. 5/9/1998: Letter of Acceptance of Hydro received by Engineer.
5. 10/9/1998: Letter of Intention to subcontract received by Engineer.
6. 20/11/1998: Signing of Subcontract: Aqua: 60%
Digby: 20%
Hydro: 20%.
7. 25/11/1998: Advance Payments by the Engineer in favor of Hydro: 2 million palu.
8. 1/12/1998: Mobilisation Digby.
9. 1/7/1999: Claim Digby to Hydro (20% of work done): 3 million palu.
10. 5/7/1999: Hydro sends its Payment Certificate to the Engineer for work (20%) done and claims: 3 million palu.
11. 10/7/1999: Engineer pays to Hydro the sum of 2.4 million palu for 20% of work done minus 20% deduction for Advance Payments. Hydro is protesting and claims 2.6 million.
12. 1/7/1999: Claim Dynam to the Engineer: 1,5 million palu. The Engineer refers Dynam to Hydro, who should be responsible for all payments as Main Contractor. Hydro refuses to pay for the reason of not having approved to Dynam as subcontractor.
13. 1/7/1999: Hydro disburses to Aqua the sum of 1 million palu as Advance Payment.

14. 20/8/1998: Engineer's Representative approves Certificate of Payment for another 20% of work done.
15. 25/8/1999: Additional claim of Aqua to Hydro: 1,25 million palu for work done (20% of the total work approved by Engineer's Representative) on top of 1 million Advance Payment.
16. 1/9/1999: Claim of Hydro to Engineer for work done (20%): 3 million palu.
17. 5/9/1999: Engineer disburses to Hydro 2,4 million palu for another 20% of work done (minus proportion of Advanced Payment).
18. 25/9/1999 Aqua unilaterally terminates Subcontract with Hydro because of default of payment.
19. 5/10/1999: Engineer notifies Hydro of expiration of Contract and enables Hydro to complete the works within a month or at least show some meaningful progress.
20. Hydro requests Extension of Time.
21. 5/11/1999: Engineer notifies Hydro of expiration of Contract and enables Hydro to complete the works within a month or at least show some meaningful progress.
22. Hydro requests Extension of Time on the argument of abnormal weather circumstances in the previous rainy season.
23. 10/12/1999: Engineer unilaterally ends Contract with main Contractor Hydro. His main argument is lack of progress and subsidiary the exceeding of the contract period.

QUESTIONNAIRE

Please, answer the following list of questions consulting case and lecture notes. The argumentation for your answer is more important than the answer!

1. Was it wise to exchange the loan of the Development Bank into local currency? How would you have disbursed this loan? Which party is in the best position to disburse a loan in hard currency: the Development Bank, the National Government, the Town Council or the Engineer?
2. Is to your opinion a Memorandum of Understanding a Contract? Why or why not?
3. What procurement method is apparently applied in country X?
4. What measures would you take to secure the quality of your Contractor at tendering?
5. What are the advantages and disadvantages of a Tender Procedure based on awarding tenders as per lowest bid?
6. At what precise date did the Contract begin?
7. What is your opinion about subcontracting? And about subcontracting to (nominated) (Sub)Contractors under systems of negotiated contracting?
8. Is the fact that the Subcontractor moved to site nearly 2 months late a ground for extending the whole Contract with the period of delay?
9. Is (ab?)normal price inflation a legitimate cause for an increase of the Contract Sum? How is that arranged in this Contract?
10. Is it common/wise to express the progress of a construction contract in percentages?
11. Can heavy rains establish a ground for Variation? And for Extension of Time? What about this case? What kind of climate does country X apparently have?
12. Is the fact that the geological reports, consulted in the Engineer's Office, appear to be incomplete/incorrect, a ground for Variation? Who should pay for the removal of the boulder?
13. What is the difference between a Variation and an Alteration?
14. Is the claim of Digby of 3 million palu for 20% of work done justified? Give reasons. Can he order the Engineer to pay?

15. Is Dynam's claim of 1.5 million palu to the Engineer justified? To whom should the claim have been directed?
16. Is Aqua's claim to Hydro of in total 2,25 million palu for 20% of work done legitimate?
17. Is Hydro's successive claim of 3 million dollars to the Engineer legitimate? What should the claim be?
18. Is the Engineer authorised to end the Contract with Hydro? And if so, on which ground?
19. Can Aqua claim continuation of the Contract under similar conditions of its subcontract, but separate from Hydro as main Contractor?
20. If the Engineer decides to complete the works with his own staff what lawful budget is left? You may ignore (the legally very complicated) issue of penalty payments (, if applicable at all):
 - a) 5.2 million palu (10 – 4.8)
 - b) 4.8 million palu (10 – 5.2)
 - c) 7 million palu (10 – 4.8+1.8)
 - d) 4.5 million palu (10 – 6.8 -1.5 + 1.8)
 - e) Another sum
21. Which sum will he still have available in practice? Will this be sufficient to complete the works?
22. Imagine that the clause of slow progress (no meaningful progress during one month with a notification period of one month) is ruled out by the Court as being in conflict with reasonable practices in the construction sector, do you still think that the Engineer is authorised to end the Contract for exceeding the contract period?

INSTRUCTION ARBITRATION GAME

A. ARBITRATION PANEL

An arbitration panel consisting of 5 persons has to come up with reasonable advises on the following questions:

1. Is the Engineer entitled to end the Contract unilaterally and why or why not?
2. Are penalty clauses applicable and if so, over which period and for how much money?
3. Who is entitled to which sums of money and who has to pay them?
4. Establish the remaining budget?
5. Should the Contract be continued and if so, why? By whom should the Contract be continued and under which conditions? Should a new arrangement be made? Who should carry it out?

Your task is above all to come up with a solution that satisfies the public interest. The cholera problem in Roughdale is still endemic!
 You are obliged to hear the parties and give them opportunity to state their case!
 Please, start with Hydro.

B. ACCOUNTANT DEVELOPMENT BANK

This person has to make sure that the Contract is carried out in a transparent and accountable manner according to the rules of the Development Bank. There is no room for additional budget.

C. MAYOR ROUGHDALE

The mayor wants a fully fledged treatment plant according to design as soon as possible.

D. ENGINEER AND ENGINEER'S REPRESENTATIVE

This office wants a fully fledged treatment plant as soon as possible. The Engineer wants to disburse as little as possible from the available funds, because it is very likely that he either has to engage another Contractor or has to complete the works himself with no additional budget. It is clear for him that Hydro cannot complete the works, because the funds disbursed for this contract have been used on another one to settle a Court Order!

E. HYDRO

Hydro wants to make money and to continue the Contract to avoid bankruptcy. Hydro is also working on another contract and has used its last bank credit to pay off the Subcontractor of the other job. This was enforced by the Court!

F. AQUA

This company wants to be paid in full to the present value of the palu for work done. The company has a cash flow problem and still interested in completing the Contract, but only, if money is coming fast. The relation with Hydro is obviously very troubled.

G. DIGBY, DYNAM

These companies want to be paid in full to the present value of the palu. It goes without saying that they want to make money and want to have additional work in the future.