/Carey

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LUMP SUM CONTRACTS: MYTH OR REALITY.

The Chilean perspective.

- Strictly private & confidential -

THE MYTH.

The Owner's myth: When I hire a contractor to build a project under a lump sum contract, the contractor should complete the work for the agreed fixed price on the agreed completion date with no claims for more payments or delay. If he is late, I will get my delay LDs.

The Contractor's myth: When I bid on a lump sum contract for a project, I will build no more and no less than the agreed and thoroughly pre-defined scope of the works with no changes or interferences from the Owner, or else I will get extensions of time and additional payments including prolongation costs.

BUT REALITY IS MERCILESS:

Pacta sunt servanda is king:

a) Lump sum can mean what the parties actually agree it to mean.

b) Absent agreement to the contrary, the "lump sum price" is a concept relating **with the price** of the works, **it does not relate to the scope of the works.**

c) **Lump sum is not the same as "turn-key" despite many times these two concepts tend to go together.**

Almost every construction contract will experience changes, suspensions, Owners interferences, etc. which will stress the lump sum price and will normally give the contractor right to a revision of the lump sum, or additional payments and also, also extensions of time and relief form (or postponement) delay LDs.

d) The poorer the definition of the scope the weaker the lump sum price.

WHERE DOES THE MYTH COME FROM?

Being this rather globally spread out myth, I do not pretend to have an answer… but see the following provisions in our Civil Code:

Art. 2003 “The contracts for the construction of buildings agreed with a contractor, who undertakes to build all of the work for a sole or unique pre- determined price, shall be subject to the following provisions:

1° The contractor may not ask for a price increase, arguing increased costs for labor costs or materials, or arguing additions or modifications to the original plan; unless a particular price have been agreed for such additions or modifications.

2° If unknown circumstances, like a hidden vice in the soil, has caused cost which could not have been foreseen, the contractor shall seek authorization to incur in them from the owner, and if the owner refuses such authorization, the contractor may resort to the judge to determine is such increased costs should have been foreseen or not, and to fix the corresponding price increase.

3°… “

WHERE DOES THE MYTH COME FROM?

None of this is public policy, only default rules and Mr. Andres Bello (the author of our Code) in his default rule is clearly saying:

Mr. Owner, no changes unless you are prepared to pay for them, and agree the price with Contractor.

Mr. Contractor, don't think about implementing changes unless you have the agreement of the Owner, or else you will not get paid for them.

At a "classroom level" a lump sum price arrangement, to work as expected, should be advisable only for construction contracts that have a well and through defined scope.

Consistent with this, with proper provisions dealing with changes or variations a lump sum contract may mitigate or control the price increase arising from changes required by the Owner.

Experience suggests that even a well drafted lump sum contract will fail to cope with a significantly poor, defective or incomplete design or work scope definition.

A POEM FOR A PREMATURE BABY

CONTRACT PRICE**.** The Contract Price shall be the single, fixed and total amount of XXX,XXX,XXX.XXX *Unidades de Fomento* plus VAT. **

Price Contract = Total Net Value + VAT

Price Contract= XXX,XXX.XXX UF*

Total Net Value = XXX,XXX.XXX UF

VAT = XX,XXX.XXX UF

Parties declare the above-mentioned price and eventually the term for the execution of the Works, shall be modified by agreement of the Parties, on the basis of new definitions and terms of the project that are being elaborated by the Owner. In these cases, the Parties must agree and sign the addendum of this contract.

A POEM FOR A PREMATURE BABY

A few examples of “premature babies”, some deliberately intended to be so, others premature by mistake:

“Fast Frack” EPCs, where the “E” is huge, and where the design and the construction tend to go, to a greater or lesser degree, in parallel.

EPCs with a very big “E” where Contractor is bound only to meet certain Owner’s requirements

In (i) and (ii), if Contractor bids for under a lump sum, it takes the design risk. More often than not, Owner gets to approve the design as it progress and Contractors contend that Owners overdo their role in reviewing and approving the design. Owner’s contend that they awarded under certain design representations contained in the Contractor’s bid, and later on, the Contractors waters down their design into a less robust, more expensive to operate, etc. solutions sheltering in the concept that, being responsible for the design, they can do whatever they want, to the extent the meet the Owner’s requirements.

Incomplete design by Owner under pure construction Contract, or an EPCs with a little “E”. -the poem-

WHEN THE PREMATURE BABY IS NO LONGER A BABY BUT BECOMES A MONSTER

Grendel and the denaturalization of the contract.

The concept of the “denaturalization of the contract” has been slowly developed by courts and local arbitrators (particularly those appointed as arbitrator *aequo et bono*.)

The main legal principles that support this theory are the duty of good faith, unfair enrichment, abuse of rights, estoppel by conduct (teoría del acto propio) and the contract interpretation principle based on the practical application of the contract by the parties.

This theory basically holds that a contract will no longer be enforceable as written because the rules and provisions agreed by the parties have been so dramatically overlooked or abused that in reality the parties conducted themselves in the prosecution of the project with total disregard of the contract provisions. In some cases these allegations are coupled with hardship arguments (*teoría de la imprevisión*).

WHEN THE PREMATURE BABY IS NO LONGER A BABY BUT BECOMES A MONSTER

This theory is argued a lot but not often prevails. Courts/arbitrators that are inclined to accept they usually point out:

(i) Massive and/or number of changes, including de-scoping and introducing a new contractor to the site to perform the work deletions.

(ii) Consistent disregard by parties of contract procedures for changes.

(iii) Owner's excessive intervention over Contractors work, particularly in connection with directing its design beyond its authority under the contract terms.

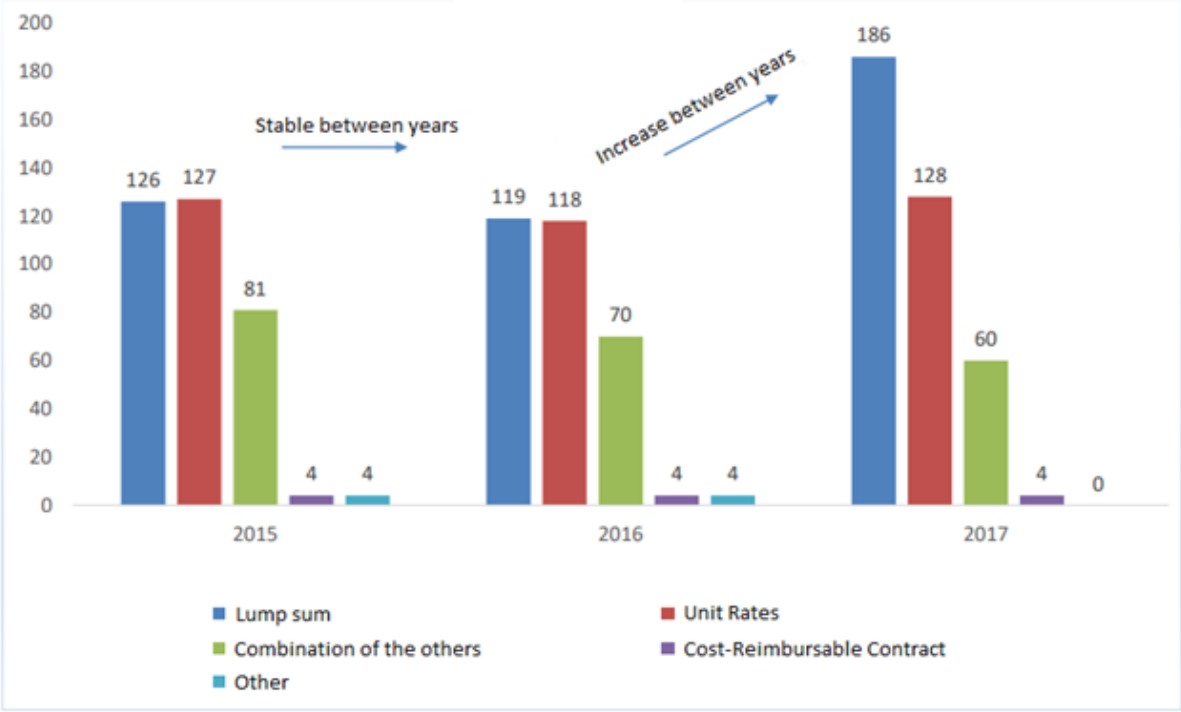
The consequences are usually to hold that contractor is not bound by the completion date and/or by the lump sum and payment of extra costs and time extensions are granted. Default legal rules in the Civil Code may be used by the Court instead of actual contract provisions being repealed or waived by the parties conduct, including the waiver of the non-waiver provision. In a way, this can be regarded as a "contract at large" principle.

Corte Suprema 375-2013 26/09/2013

I found a couple of papers dealing with this same concept in connection with public works in Perú and Spain.

SOME STATISTICS.

Number and percentage of contracts subscribed during 2017, crossed by type of contract.
Sample: 59 companies / 378 contracts.

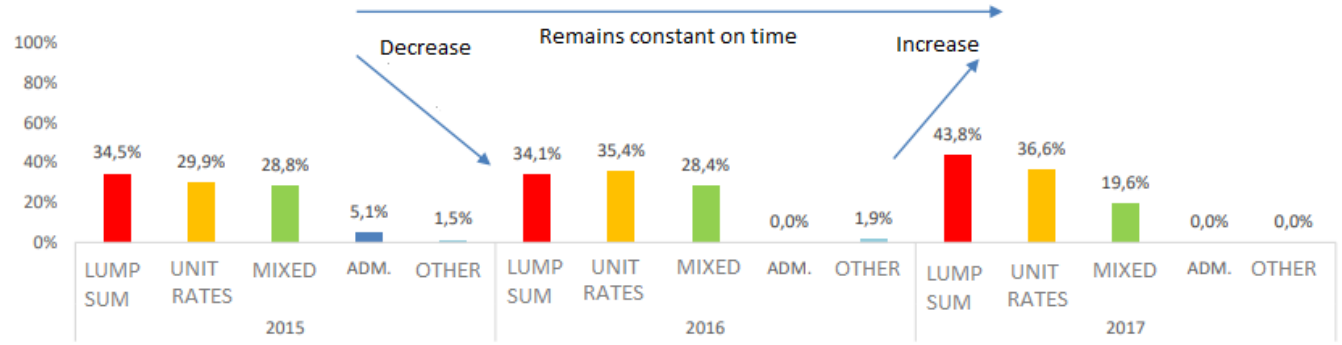


During 2017, "lump sum" contracts prevailed with a 49% of the total, "unit rates" and "mixed" contracts declined in importance and "cost-reimbursable" contracts remained as the least important regarding the number of cases.

SOME STATISTICS.

Number and percentage of Contracts by sector where a conflict was generated

Total Sample: 59 companies / 194 contracts.



	2015						2016						2017					
	LUMP SUM	UNIT PRICE	MIXED	ADM.	OTHER	TOTAL	LUMP SUM	UNIT PRICE	MIXED	ADM.	OTHER	TOTAL	LUMP SUM	UNIT PRICE	MIXED	ADM.	OTHER	TOTAL
Mining Industry	5	1	46	0	0	52	6	3	33	0	0	42	15	5	14	0	0	34
Energy	3	9	0	0	0	12	2	12	0	0	0	14	6	0	0	0	0	6
Industry	3	0	0	0	0	3	3	0	0	0	0	3	15	0	0	0	0	15
Trade	1	0	0	0	0	1	0	0	0	0	0	0	0	0	0	0	0	0
Subway	0	7	0	0	0	7	0	2	0	0	0	2	0	7	8	0	0	15
Concessionaries	1	0	0	0	0	1	1	0	0	0	0	1	0	0	0	0	0	0
Ministries	39	40	10	10	3	102	27	36	12	0	3	78	22	53	16	0	0	91
Others	15	1	0	0	0	16	15	3	0	0	0	18	27	6	0	0	0	33
TOTAL	67	58	56	10	3	194	54	56	45	0	3	158	85	71	38	0	0	194
Column %	34,5%	29,9%	28,8%	5,1%	1,5%		34,1%	35,4%	28,4%	0,0%	1,9%		43,8%	36,6%	19,6%	0%	0%	

In Mining most of the divergences are generated in type 4 Contracts.

SOME STATISTICS.

Variations of price?

Sample: companies with conflicts that declare to have had variations in the original contract (37)

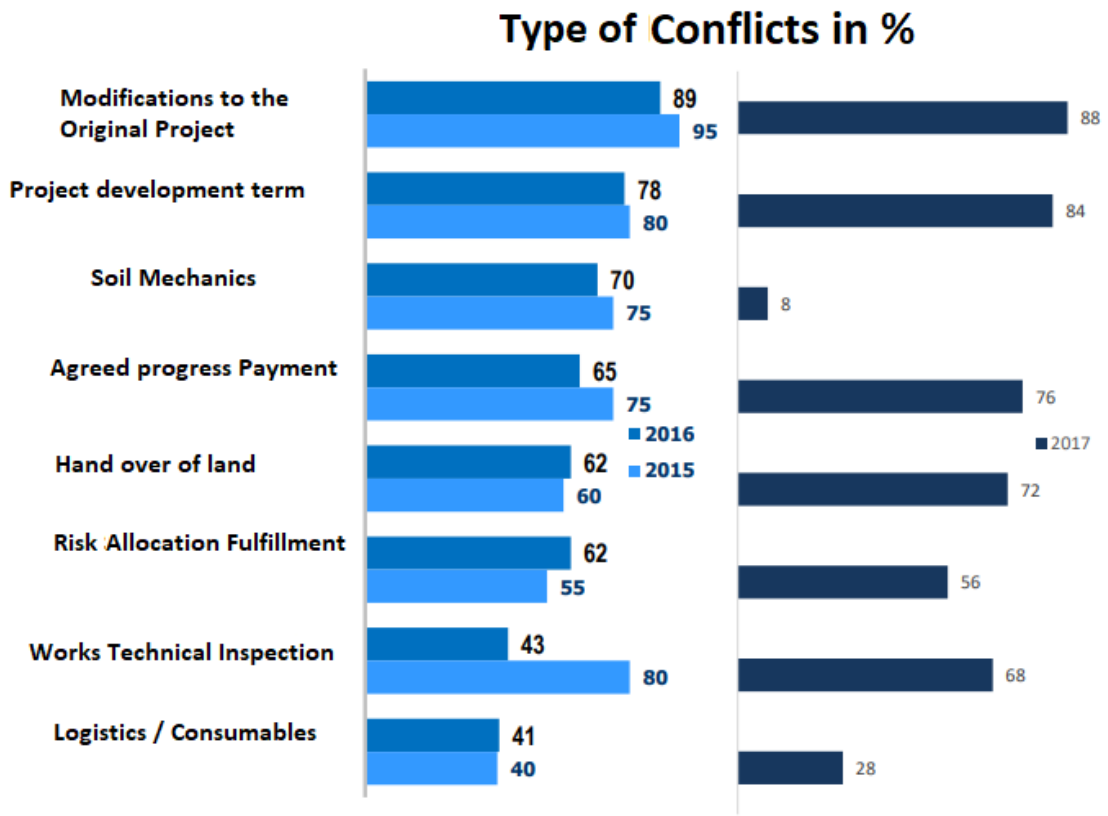
The companies that declared to have conflicts (39) and that also experienced variations of the original contract (37), in 100% of them there were variations in the Price. This percentage had decreased since 2014 to 2016 but it increased in 2017. The variations were near 17% of the original price, lower than in previous surveys (21%).

Previous survey	
2015	2016
96%	94%

B	37	9	8	20	31	14	7
	Average of Percentages 2017						
%	16,6	19,1	8,4	19	18,4	22,9	26,7
	Average of Percentages 2016						
%	21,1	11,3	23,8	23,1	21,3	19,7	17,9

SOME STATISTICS.

Conflicts produced after signing the contract
Sample: 39 companies



The general trend is an increase in the conflicts percentage.

The most mentioned type of conflicts after signing the contract is related to Modifications to the Original Project (88%).

The counter-trend is in Soil Mechanics with a substantive decrease regarding previous years.

It is important to note the Works Technical Inspection category decreased from 80% in 2015 to 43% in 2016.

SOME STATISTICS.