

STANDARD FORMS OF CONSTRUCTION CONTRACTS IN ROMANIA

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Abstract. Construction industry in Romania is under pressure to modernize in order to cope with the new demands of development and convergence with EU. Contractual procedures in construction have to become an integral part in this process of modernization. The article makes an introduction to the advantages of standard forms of contract and professional contract administration in construction and presents the current state-of-the art in the use of standard construction contracts in Romania. Some practical conclusions and recommendations are presented considering the need for further contract studies.

Key words: standard forms of construction contracts, contract administrator, FIDIC

1. Introduction

Construction sector occupies a strategic place in the economy of developing countries (Ofori, 2007). This is particularly true in the case of Romania, a developing European country and a new member state, which in addition to its developmental needs has to respond to the pressure of convergence with the rest of EU. Construction industry has to deliver the constructed assets indispensable to state development and modernization: infrastructure, buildings and a variety of constructed facilities needed for the majority of human activities. (World Bank, 1984, p. 3). As such it is expected that the sector will remain important in the coming decade, consequently leading to an increase in the volume and complexity of construction projects. While there has been technical, technological, economical progress in the last years, construction industry in Romania is still dependent on some of the "historical" working methods. One of the under-reformed areas is the

field of procurement and construction works contracts used by clients and contractors in relation with their contract partners.

2. Standard construction contracts and contract administration

2.1 Standard construction contracts

There is a modern trend to regard the construction contracts not only from a legal perspective but also as a part of the management tools package attached to a project. This perspective encourages the use of standard (also called typical or model contracts) provided by various professional organizations involved in construction, contracts that are usually grouped under families or contract suites, to name just a few: AIA (U.S.), NEC, JCT (UK) or FIDIC (international).

The advantages brought by the use of standard forms of contracts are largely supported by professional and scientific

communities (Bubshait and Almohawis, 1994) and also endorsed by international financial institutions and development banks (FIDIC, 2006).

Considering the need to modernize construction procurement and contract system used in Romania, the current article discusses two key issues related to the use of standard contracts:

- the role of the standard contract in balancing the (contractual) relationship between the client (employer) and the contractor;
- the introduction of professional contract administrator as the client's agent.

2.2 Contractual balance and moral hazard in construction

Construction contracts are rather different from other commercial agreements - the object of the contract (the construction) has a high degree of uncertainty as it is not there at the time of contract execution and at the same time is an expensive product, with a high level of technical and technological complexity. While the contract documents will provide some definition of the contract object (in the form of a more or less detailed project and specification) the high degree of project complexity still leaves a lot of room for uncertainty on the way to the final result. This makes the task of administering the contract an important part of the larger process of "managing uncertainty" as Winch puts it (2010, p. 133). In the same line of thought Winch raises the question of "moral hazard" - in brief how can be the client sure that the contractor will perform under the contract in good faith bringing it to the desired outcome?

One of the main underlying conditions of moral hazard is the "lemon problem" as described by Akerloff (1970), basically a situation arising from the information

asymmetry since the buyer of a product or service is less informed on its quality than the seller, thus making the buyer being more exposed to contractual dishonesty.

In the case of construction the asymmetry is likely to be more pronounced and the potential risks for the client higher. As a rule, the contractor possesses better technical and managerial skills than the client and also has a better perspective on future potential project related risks. The absence of a proper contract to provide clear terms and procedures regarding all relevant aspects and a balanced distribution of risk between the parties may leave the less informed client exposed to the risks associated with moral hazard and a potentially severe compromise regarding desired outcomes.

2.3 . Advantages of standard forms of contracts

Broome and Hayes (1997) propose a comparison between traditional and standard contracts and argue that the first present some structural weaknesses related to the lack of "clarity" while the latter introduce a number of advantages, benefiting from clearer and easier to understand provisions which help to define procedures, contractual roles and methods of solving eventual disputes.

Murdoch and Hughes (2008) argue that these contracts are subject to the principle "similar projects demand similar contracts" (p. 101), contribute to a fair distribution of risk between the parties but also pose problems that arise from the complexity of these forms of contract and the difficulty of tracking possible contract amendments.

Smith (2009, chapter 11) also shows the natural advantages brought by standard forms of contracts through familiarity both within industry (clients, consultants, contractors) as well within the legal and

judicial system in general, a factor which facilitates understanding and resolution of disputes between the parties.

Thus, the standard contract becomes one of the tools to control the moral hazard inherent in construction projects and it is a form of contract designed specifically to balance the relationship between contractor and client. The repetitive content, easy to understand formulation and clear procedures – make standard contracts practical and useful instruments regardless of the client's experience in construction procurement.

2.4 . The contract administrator

Some forms of contractual arrangements require a contract administrator defined simply by Murdoch and Hughes (2008, p. 250) as the person in charge with “monitoring the contractor’s work”. As previously underlined, the contract by itself is not enough to answer the problem of moral hazard and the asymmetry of information between the client and the contractor. The second key-element is the presence of a third contractual party – namely the contract administrator.

Regardless of the title (the "Engineer" in FIDIC, Architect / Contract administrator in JCT, Architect, Construction Manager AIA) and the detailed role and specific duties under the contract, this third party is usually acting as the client’s agent or in some instances as an independent certifier, responsible to administer on client’s or on behalf of the parties the financial-technical-managerial-executive procedures entailed by project. These two situations, either as client’s agent or independent certifier are captured differently in various contracts and moreover the contract administrator may be required to act from both perspectives within the same contract, depending on what the situation requires as

an agent of the client when monitoring, inspecting work progress or consulting the client or as an independent certifier whenever he certifies payment or clarifies contract disputes (Murdoch and Hughes, 2008, chapter 18). This double role raises critiques related to possible ambiguities - issues that have been addressed in several recent updates – like in the case of FIDIC, where starting with the 1999 revision, the role of the Engineer is well defined in both situations (Ndekugri *et al.*, 2007).

3. Works contracts in Romania

The historical condition of the pre 1990 socialist economy meant that the contracting parties were more or less representing the same player – the state. Under this system, the work used to be performed by a general contractor (usually a large state enterprise) and the construction phase was preceded by a full design provided by a state design institute covering all design specialties. As a result the contracts used to be rather sketchy regardless of project size, complexity or cost. As such, the nowadays industry “inherited” and is more used to a certain contractual simplicity and is more accustomed with a basic traditional procurement route. Regarding the formulation of contracts, what happened after 1990 was mainly concerned with the update of main legal contract provisions to respond to the new legal statutory frame. Very little has been done to prepare the managerial and executive parts of the contracts to offer better adapted managerial tools to suit the new economic conditions.

This resulted in a low degree of contractual harmonization with:

- the progress of procurement routes and the emergence of new types of collaboration in construction (such as design and build formulas adopted especially by the public sector);

- the specific and technical-operational working procedures that accompany the modern management of complex construction projects.

With the internationalization of the construction sector and the new presence of multinational contractors, a phenomenon appeared related to a tendency to “import” forms of international contracts either as complete or partial versions, naturally less familiar to the local clients in both legal terms and working procedures. Under these circumstances, the issues of moral hazard remain largely unaddressed and conceptually unrecognized in contracts. The clients from both private and public sectors are not paying enough attention to the know-how asymmetry when facing and entering an agreement with a contractor as well as to the need to manage this risk through contractual means and by employing a consultant as contract administrator (project manager). The clients tend to show an exaggerated optimism and focus extensively on establishing an initial price of the contract, without a clear understanding on the importance of setting clear rules regarding the management of change regardless of the source of the change (claims, disputes, additional works and so on).

Typical contracts are rarely used (with a notable exception discussed in the next section) as this option and its advantages are insufficiently disseminated and there are few local professional organizations to promote such initiatives. Another exception to be noted is referring to the multinational companies that are regularly procuring construction works (like in Oil & Gas) and therefore applying either in-house standard contracts or some industry-specific adaptation of international versions. The contract administrator charged with a specific role of executive management of construction contracts remains a rather

unknown figure, even though the local industry, under the effect of EU-funded projects, became recently more familiar with the idea of “project manager” as the client’s agent. However, in the absence of clear contractual provisions to detail the role and tasks of the project manager, the potential advantages brought by professional management remain underexploited.

To this adds the fact that the construction industry, still in its first stages of modernization, has not yet formed a body of knowledge or a significant number of contract managers / consultants familiar on one side with the international contracting and procurement practice, and the local specificities and working culture on the other side. Hiring exclusively international consultants is not necessarily a sustainable solution for at least two reasons: they are too little acquainted with the local working environment, law and regulatory framework, and at the same time in a relationship between a local client and an international contractor may be prone to bias in favor of the latter (a possible former partner from the international construction market).

4. FIDIC in Romania

Under the auspices of local construction market internationalization emerge the first attempts to “institutionalize” standard contracts. The first instance is not born from within the industry but emanates from the public client (represented by the government). Thus, between July 2008 to May 2009 is in effect the application Joint Order of Ministry of Transport, Finance and Public Works no. 915/2008, which introduces the mandatory use of FIDIC (Red Book, Yellow Book and Green Book) using a Romanian translation. This rather brief application is resumed with the Order of Ministry of Transportation and Infrastructure no. 146/2011 which reinstates

the use of FIDIC conditions (mainly - Red Book - where employer supplies design and Yellow Book where the design is supplied by the contractor) but this time limited to:

- agencies subordinated or under the authority of Ministry of Transportation and Infrastructure;
- transportation infrastructure works of national importance funded publicly;
- contracts with an estimated value exceeding the threshold of EUR 4,845,000 (EUR 5,000,000 today).

Georgescu (2011) argues that the application of FIDIC in its first attempt was interrupted in 2009 due to issues of incompatibility and contradictions generated by poor translation and the inadequacy with the local law and regulatory framework. Looking further, a joint position paper of EIC and FIEC (2012) is critical regarding the alteration of the standard FIDIC provisions due to specific clauses introduced by Order no. 146/2011 leading in effect to the alteration of the contractual balance between the parties (provided by original version) in client's favor. A more straightforward explanation is provided by Gillion (2012) by detailing that the altering clauses referring to Yellow Book (the FIDIC design-build form of contract) are in fact outsourced from the Silver Book (the FIDIC form of contract for EPC / Turnkey projects).

While it is not the purpose of the current article to enter the subtleties of various forms of FIDIC contracts, this issue is relevant especially when describing the status of standard contracts implementation in Romania.

Gillion (2012) suggests that there is in fact a trend common to public purchasers of construction works in CEE when using FIDIC - manifested by an attempt to alter the original contract provisions in the favor of the employer. According to Gillion,

Order no. 146/2011 has added to the Yellow Book clauses, articles, originating from Silver Book, shifting the design responsibility fully to the Contractor (even if some portion of design is supplied by the Client). In addition, the alterations limit the Engineers duties as independent certifier, shift additional risks to the Contractor and limit the price premium attached to these risks. The author points out several effects of these alterations:

- the restriction of contractor's rights to request additional payment/ extension of time for delays arising from late site possession due to the process of expropriation (a risk that in EIC's opinion has to be actually incurred by the Client);
- the capping of Contract price adjustments at 10% (only in Romania) adjustments otherwise permitted by the Yellow-Book as payments for variations instructed by the Engineer.

Gillion's conclusion is harsh: „Due to its far-reaching effects for contractors, the new FIDIC-based General Conditions of Contract introduced by the Romanian Government in March 2011 for road works projects have become an important casus belli for the EIC and international contractors operating in Romania” (Gillion, 2012, p. 8). In this situation, EIC and FIEC (2012) argue in favor of a balanced contract and reject the alteration of FIDIC standard form as detrimental, by making reference to the provisions EIB Guide for Procurement (2011) highlighting relevant passages: “the contractual conditions are fair and reasonable” (EIB, 2011, p. 14), to EBRD Procurement Policies and Rules (2010) "3.24 Conditions of Contract. The form of contract to be used must be appropriate to the objectives and circumstances of the project. Contract conditions shall be drafted so as to allocate the risks associated with the contract

fairly, with the primary aim of achieving the most economic price and efficient performance of the contract.... Wherever appropriate, standard forms of contract incorporating generally accepted international conditions must be used" (EBRD, 2010, p.14) or to the World Bank" Guidelines procurement of goods, works, and non-consulting services (2011): „ The conditions of contract shall provide a balanced allocation of risks and liabilities" (World Bank, 2011, p. 20).

On the other hand the government's risk-aversion is explicable as the government and its agencies are liable and responsible in front of EC for any expenditure arising under such contract - so in turn results this attempt to minimize the risks by shifting them to the contractor. This happens mainly since the conflict, "casus belli" as Gillion calls it, arises within the public procurement system especially in the context of European funded projects. It is rather clear that the local government and its agencies are attempting to support the public interest by introducing protective clauses mostly related to the financial risk of the contract. This risk aversion may be specifically related to several issues but we will mention here only two:

- The recent history in public procurement marked by delays and cost overruns - although here we draw attention to the fact that Romania is not by far a singular case here (for further reference see the excellent study by Flyvbjerg and COWI, 2004);
- Lack of technical-executive-contractual know-how in monitoring project implementation and a significant body of contract administrators (we do not refer here to theoretical experts or consultants but professionals with practical track record under the conditions of the

local construction industry, able and ready to offer professional advice adapted to local realities).

The governmental concern regarding the contracting risks is legitimate and real and the answer to that lies (in great part) in the adequacy of contract provisions. Still, when discussing the opportunity of altering the provisions of a standard contract form, some ideas need to be stressed:

- in practice, the contractors will only accept risks deemed as manageable. The acceptance of such risks will draw a risk premium mechanism (additional payment) as the contractor will require to be reimbursed for accepting it. Also, even if the contractor is interested in taking the project he will be reluctant to accept responsibility for risks like delays caused by the expropriation process as long as he is unable to exercise control over the process and is not properly reimbursed for this service;
- Altering a standard form of contract even by adaptation of provision from the same family of contracts is a legal stretch that might not work technically by ignoring the organizational, technical and managerial realities or the project environment. As such, specific provisions deriving from an EPC contract might prove detrimental for both parties when "pushed" into a design-build agreement;
- The contract is not about the limitation of risk but rather about risk allocation to the party best prepared to deal with it. Therefore, switching for example the expropriation risk to the contractor might prove inefficient as the contractor might be poorly prepared to handle expropriation procedure and finally cost the project a greater

- deal of additional money and/or time;
- Decreasing or managing the risk of cost escalation is a rather fundamental question to any construction contract, and certain procurement routes and corresponding contracts to guarantee a maximum price for the Employer (like the EPC or FIDIC Silver Book) have a different approach if compared with a design-build agreement which distributes the risk of cost escalation between the client and the employer (a process managed by the Engineer). Hence an “artificial” capping of the contract final cost (why 10% and not 5% or 25%?) in a design-build agreement (which by default allows for change including the cost) might prove maladapted to the rest of contract provisions and compromise other contract mechanisms as well as the reasonable allocation of risks between the parties;
 - Switching a greater extent of financial risk to the contractor without providing compensation mechanisms may result in breaking the contractual balance and in extremis incurred losses or even bankruptcy. Depending on the time of contract dissolution, this situation can in fact result in greater spending by the employer generated by cost of delay and contractor replacement (a value that could easily exceed limit of 10%).

It is reasonable to conclude at this stage that for the time being:

- Very few contracts have been executed in Romania under FIDIC contract conditions
- The current situation might lead to pre-contractual blockage (in the sector impacted by FIDIC conditions

- namely transport infrastructure of national importance) generated by the fact that neither parties are prepared to enter contracts containing conditions considered incompatible with their roles;
- Progress from both sides is required to overcome this status quo.

6. Conclusions

We have shown that the change in procurement routes and corresponding contractual arrangements has to cope with the current modernization and internationalization of the construction industry in Romania.

The first part of the article presented the advantages brought by the use of standard forms of contracts including balanced (fair) risk distribution between the client and the contractor and the presence of the professional contract manager as a way to compensate the inherent information asymmetry between the client and the contractor and improve the managerial procedures throughout the project. The next section presented some of the current contractual developments in Romania, including the unfamiliarity with standard forms of contracts and modern contractual arrangements in construction.

The use of FIDIC is presented as a case study reflecting to some extent the state-of-the-art and the barriers encountered in the local implementation of a standard contract form. A first conclusion would be that the standard contract forms need dissemination and endorsement from within the professional community. This can be achieved through further contract studies as well as with the help of the organization(s) supplying such forms of contracts.

Both private and public clients need to become more aware and update their

information regarding alternative procurement routes and the use of corresponding contracts. The public sector especially has to approach carefully its double role as a client for construction works and industry regulatory framework originator, a situation which, as has been seen in the case study, may lead to a rather confusing status in which in order to protect its interests as a potential client, the public sector proposes a framework (in our case the FIDIC contract) under a form potentially leading to blockage and inconsistent results in practical project implementation.

A solution to overcoming this situation is further consultation involving international bodies but also local professionals, considering besides the legal provisions essential aspects related to the technical and operational management of construction projects under any contractual standards.

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