Claims for head office overheads and profit (and their applicability to NEC3)

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Introduction

Loss of head office overheads and profit is a well-established head of claim that has been discussed and approved by the courts, together with the usage of formulae to calculate it. It is usually pursued by contractors in the event of qualifying delay, over and above other items such as disruption, additional preliminaries, extension of time etc.

The logic behind these claims is that the contractor, by having committed resources during the period of delay, is deprived of its opportunity to win other projects (by being unable to allocate resources to manage them) and its turnover is reduced. As a result of this deficit, the Contractor is unable to make the required profit and contribution to its total head office overheads.

Depending on the contract form, such claims could be valid if certain criteria can be fulfilled. Some contract forms allow for such recovery (by way of example, unamended JCT contracts), whilst in other, such as the NEC3, these kinds of claims are seemingly not provided for, although there are circumstances in which they can be proven meritorious.

Calculation

In order to succeed with delay claims regarding loss of overheads (and profit), the contractor would generally need to prove that-

(a) its turnover was adversely affected by the delay; and

(b) as a result of the delay, it was prevented from earning a contribution to its head office overheads (and profit)

The three formulae commonly used for calculating the loss, are based on the logic that since the contractor is prevented (due to the delay) from releasing its resources in order to earn the contribution to overheads (and profit) from another project, it must then earn an equivalent contribution from the delayed project.

These are as follows:

Hudson formula

It is based on the contractor's percentage for overheads (and profit) as allowed for in the tender. It is arguably more suitable when assessing loss arising from a delay due to additional work, when a variation or other clause within the contract is used, rather than due to breaches of contract where the remedy is by way of damages (where the next formulae are more suitable):

(Tendered head office overheads (and profit) % / 100) x (contract sum / contract period) x period of delay

Emden's formula

Similar to the Hudson formula, but using the actual head office overheads (and profit) percentage as this is calculated from the contractor's annual accounts, dividing the total overhead cost and profit by the turnover[1]; this could entail taking the average values of the last 2 years.

(Actual head office overheads (and profit) % / 100) x (contract sum / contract period) x period of delay

[1]: By way of example, looking at a company's income statement within its published accounts:
Actual head office overheads and profit % = (gross profit + administrative expenses) / turnover) x 100

Eichleay's formula

Similar to *Emden's* formula, using the actual overheads, but instead of the contract sum, the total contract value (including variations, remeasurement etc.) is used. Mostly used in the United States (where it found approval by the US courts) whereas the terminology differs[2]:

Contract billings / Total billings for contract period x Total overhead for contract period = Overhead allocable to the contract

Allocable overhead / Days of performance = Daily contract overhead

Daily contract overhead x No. days delay = Amount claimed

The logic

In the simplified example below (Figure 1), the contractor has planned the project turnover throughout Year 1, 2 and 3 according to the submitted tender and programme (line B, Expected t/o). This, together with other projects, creates an estimate of the company turnover shown in line D – E – D. Line A – A represents the head office overheads which, as originally planned, are covered by the expected project turnover.

The delay creates a different turnover profile for the project (line C, Actual) which is below the level of overheads during years 1 and 2; accordingly, the deficit affects the company turnover for the same period (line D-D-D, actual). What this means for the period of delay (year 1 and 2), is that the contractor's reduced turnover is not sufficiently contributing to the head office overheads as planned.

It could be argued that nothing is stopping the contractor from pursuing other projects using additional resources to manage them. This is one of the tests used in courts, i.e. the contractor needs to demonstrate that such a solution was not possible (e.g. because its business model is based on in-house resources rather than agency staff).

Whilst, after the delay period the project turnover is realised, the company's turnover is reduced for years 1 and 2. The increased project turnover in year 3, could possibly put further strain to the company's available resources due other planned work.

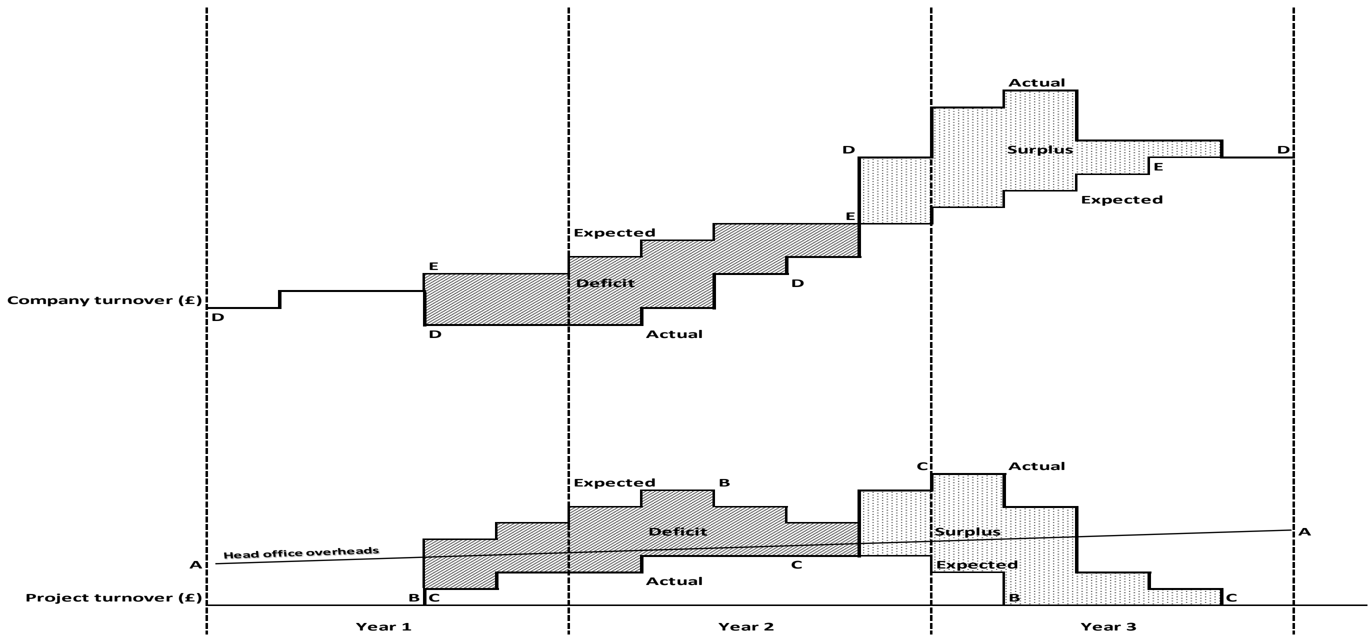

Figure 1

[2]: As stated by the Federal Circuit in Nicon, Inc. v. United States, 331 F.3d 878, 888 (Fed. Cir. 2003)

Applicability to NEC3

Unlike the JCT contract which, in its unamended form, does not prevent the parties from seeking remedies under common law (e.g. clause 4.23 of the JCT D&B 2016, "Reservation of Contractor's rights and remedies"), at first glance, the NEC3 ECC contract does not provide for this kind of recovery. Clause 63.4 states:

"*The rights of the Employer and the Contractor to changes to the Prices, the Completion Date and the Key Dates are <u>their only rights in respect of a compensation event</u>*." (Emphasis added)

That implies that recovery for the Contractor under common law damages is excluded, because all remedies are provided for in the contract by the compensation event mechanism. Furthermore, in the listed compensation events, clause 60.1(18) includes any breaches of contract by the Employer, which are not under any other category.

In addition to the above, the Defined Cost which is used for the assessment of compensation events, either under the Schedule of Cost Components (SCC) or the Shorter Schedule of Cost Components (SSCC) has no category of costs relating to head office overheads and profit. Lastly, by clause 52.1, all the Contractor's costs that are not included in the Defined Cost, are treated as included in the Fee. It follows that the Fee is deemed to include head office overheads and profit as well as any other costs not set out in the SCC or the SSCC.

However, notification of compensation events is time barred by the *defects date* (clause 61.7). What if there is a breach by the Employer (or the Project Manager acting as its agent) after that date?

One could argue that, after the *defects date*, there could be no delay caused as the works would have been completed some months or even a year before, depending on the contract; but what if the breach would result in the Contractor being unable to pursue other projects? Wouldn't that entitle him to recovery of head office overheads and profit under common law since its rights under the contract are time barred and the cause of the loss had occurred after that time limit?

An example could be that the Employer delays the release of a Performance Bond (secondary Option X13) which restricts the Contractor's bonding capacity for other projects. Or that the Project Manager delays in issuing a certificate (e.g. Defects Certificate) and that delay somehow prevents the Contractor from allocating resources to other projects and forces it to decline or refrain from pursuing new work?

It is highly possible that, provided the requirements are satisfied (see conditions (a) and (b) in "Calculation", *supra*), such a claim would have merit and that the contractor would be able to recover its proven loss using one of the formulae.

Conclusion

There is a plethora of court cases that have dealt with contractors' claims for recovery of head office overheads and profit, albeit the applicability to the NEC3 contracts, with the particular circumstances as set out above, has not been tested.

The conclusions of Akenhead J at paragraph 541 of his decision in *Walter Lilly & Company Limited v (1) Giles Patrick Cyril Mackay and (2) DMW Developments Limited another* [2012] EWHC 1773 (TCC) could summarise the principles that should be followed in the assessment of these claims:

(a) A contractor can recover head office overheads and profit lost as a result of delay on a construction project caused by factors which entitle it to loss and expense.

(b) It is necessary for the contractor to prove on a balance of probabilities that if the delay had not occurred it would have secured work or projects which would have produced a return (over and above costs) representing a profit and/or a contribution to head office overheads.

(c) The use of a formula, such as Emden or Hudson, is a legitimate and indeed helpful way of ascertaining, on a balance of probabilities, what that return can be calculated to be.

(d) The "ascertainment" process under Clause 26 does not mean that the Architect/Quantity Surveyor or indeed the ultimate dispute resolution tribunal must be certain (that is sure beyond reasonable doubt) that the overheads and profit have been lost. HHJ Lloyd QC was not saying that assessment could not be part of the ascertainment process. What one has to do is to be able to be confident that the loss or expense being allowed had actually been incurred as a result of the Clause 26 delay or disruption causing factors.

NB: Akenhead J, refers to HHJ Humphrey Lloyd QC addressing the "ascertainment" issue[3] in *Alfred McAlpine Homes North Ltd v Property and Land Contractors Ltd* (1995) 76 BLR.

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[3]: Clause 26 in the JCT Standard Form of Building Contract With Contractor's Design 1998 (WCD 98), similar to clause 4.20 ("Notification and ascertainment") of the JCT Design & Build Contract 2016, regarding Loss and Expense.