

CONTRACTUAL RISK ALLOCATION IN CONSTRUCTION CONTRACTS IN NIGERIA



Introduction

In today's construction industry, navigating an increasingly volatile and unpredictable business landscape has become a significant challenge. Economic fluctuations, regulatory changes, supply chain disruptions, and unforeseen project complexities create a heightened level of uncertainty for construction projects. As a result, the need for robust risk allocation and comprehensive risk management strategies has never been more critical in construction projects.¹

To effectively manage these uncertainties, it is important to understand what constitutes a risk in the context of construction projects. A risk is the potential of a situation or event impacting on the achievement of specific project delivery or objective. Risk can be perceived either positively (upside opportunities) or negatively (downside threats).

This article aims to examine how contractual risk is allocated in Nigerian construction contracts and its impact on the construction industry.

Common Risks in Construction Projects

There are varying forms of risk inherent in specific projects in the construction industry. Some of these risks are common and can be anticipated from the outset during contract drafting, while others are more difficult to identify and emerge unexpectedly during project execution. By recognising these common risks and implementing effective risk management strategies, stakeholders can minimise potential negative impacts and improve the likelihood of a successful project outcome.² These common risks can be categorised as:

1. Financial risk: this type of risk includes cost overrun where the actual costs of a construction project exceed the estimated costs, delayed payments from clients, and foreign exchange challenges for projects that involve the importation of materials or labour, amongst others.

2. Legal risk: this type of risk involves disputes over contractual obligations such as payment delays, design variations, or disagreements over contract terms. Non-compliance with state regulations can lead to legal actions, penalties, project shutdowns or sometimes reputational damage.

1. Nitank R., Trivedi M.K., "Risk Mitigation in construction contracts" <https://www.irjet.net/archives/V3/I2/IRJET-V3I2163.pdf> (last accessed 13/09/2024)
2. AEI Consultants, "Top Construction Risks and How to Mitigate Them" <https://aeiconsultants.com/top-construction-risks-and-how-to-mitigate-them/#:~:text=To%20manage%20construction%20risks%20effectively,time%2C%20money%2C%20and%20reputation.> (last accessed 12/09/2024)

3. Environmental risk: these are risks borne by external factors that arise from environmental conditions or unforeseen natural events such as pandemics, earthquakes, floods, hurricanes etc. which usually have significant impact on the project's success.

Other types of risks include political risks, such as changes in government policies, political interference, or corruption, which can impact project approvals, funding, or operations. Additionally, there are safety risks, which involve the potential for worker injuries or as well as potential damage to equipment and property which may lead to project delays, increased costs, and legal liabilities.

Principles of Risk Allocation in Construction Contracts

Traditionally, construction contracts have often allocated a disproportionate amount of risk to contractors. This approach can discourage contractors from submitting bids or lead to inflated bid prices, as contractors factor in the additional risks. As a result, the project may become financially unviable due to the increased costs. To avoid these issues, a more balanced approach to risk allocation is crucial. Bunni suggests four key principles for allocating risks in construction contracts :³

- Which party can best control the risk and (or) its associated consequences?
- Which party can best foresee the risk?
- Which party can best bear the risk?
- Which party ultimately most benefits or suffers when the risk eventuates?

In addition to these principles of risk allocation, other considerations for risk allocation include:

- **Risk Transfer through Insurance:** insurance is often used to transfer specific risks, thereby protecting both parties from potential financial losses. For example, the term of the contract will require the party carrying a certain risk to ensure that there is commensurate insurance policy put in place for the party is protected.

- **Liquidated Damages:** The parties to a construction contract can predetermine the amount of compensation payable when the contract is breached. This provision is designed to compensate for anticipated loss without the need for legal disputes. There is a limit to the amount that can be claimed as liquidated damages and usually not exceeding a specific percentage of the total contract price.

3. <https://globalarbitrationreview.com/guide/the-guide-construction-arbitration/fifth-edition/article/allocation-of-risk-in-construction-contracts#:~:text=Bunni%20proposes%20that%20the%20following,can%20best%20bear%20that%20risk%3F> (last accessed 12/09/24)

- **Performance bonds and Payment Guarantees:** To protect both parties from risks of non-performance or non-payment, performance bonds and payment guarantees are often included in construction contracts.
- **Force Majeure:** the force majeure clause addresses allocation of risks arising from unforeseen events such as natural disasters, pandemics etc by determining which party that will be responsible for the delays and costs.
- **Changes and Variation orders:** changes to the project scope should be handled through a clearly defined process for handling these changes and responsibility for such changes in the contract.

While these principles provide an objective framework, the final allocation must account for the specific project's context. Employers must weigh the efficiency of theoretical risk allocations against practical considerations, including political and market dynamics, contractor capabilities, and the needs of project financiers. Political pressures, economic conditions, and market competition can all influence the employer's approach to procurement and

Risk Allocation in Construction Contracts in Nigeria

Nigeria construction contracts typically draw upon general international principles of risk allocation from recognised standard forms of contract such as the FIDIC suite of contracts, Joint Contracts Tribunal (JCT) and the Federal Ministry of Works contract which is a variant of the JCT. These standard contracts include detailed provisions on risk allocation, including how to manage delays, price fluctuations, and dispute resolution.⁴

The construction industry in Nigeria however faces unique challenges, including fluctuating material prices, currency devaluation, and political instability that require specific adaptations in our contractual arrangement. These factors increase the complexity of risk allocation in Nigerian contracts. Therefore, Nigerian construction contracts often contain provisions for price escalation, currency fluctuation, and force majeure to address some of these risks.

Inflation and Currency Fluctuation

The rising inflation rates of building materials and the weakening of the Nigerian Naira against global currencies significantly impact construction projects in Nigeria.

4. Compare and Contrast Risk Allocation clauses in Africa construction and infrastructure projects <https://www.squirepattonboggs.com/-/media/files/insights/publications/2017/05/compare-and-contrast-risk-allocation-clauses-in-african-construction-and-infrastructure-projects/compare-and-contrast-risk-allocation-clauses-in-african-construction-and-infrastructure-projects.pdf?rev=d1fcbb7ea4b2449194731755002141f3> (last accessed 12/09/24)

These factors disrupt cash flow projections, making it challenging to meet the financial obligations of projects. One way to mitigate this risk in Nigerian construction contracts is by incorporating currency escalation clauses. These clauses define when adjustments should be made, such as when currency fluctuations exceed a specified threshold or when certain payment milestones are reached. This helps protect both parties from financial losses due to currency volatility.

Force Majeure

Force Majeure is a clause that parties to the contract can incorporate in order to address risk arising from unforeseeable events. A force majeure event usually does not arise by reason of either party's negligent act but it is usually an event or series of events outside of the parties' control. The occurrence of the event must have been unforeseen and inevitable, thereby making the fulfilment of such obligation in respect of the contract to be impossible. The COVID-19 pandemic, resulting in widespread closures and economic disruptions, is a prime example of a force majeure event. It is important to note that the language of the force majeure clause is a key determinant in ascertaining whether the force majeure clause will apply. Force majeure clause should be drafted not just in a generic sense addressing general disruptions, but should incorporate a comprehensive scope addressing a range of potential events, both foreseeable and unforeseeable. Additionally, a well-crafted force majeure clause usually outlines the steps and procedures parties must follow in the event of a force majeure occurrence

Conclusion

Effective risk allocation is an important factor in successful construction projects in Nigeria. By carefully considering the various forms or factors that influence risk, parties can allocate risks in a manner that promotes project efficiency, fairness, and sustainability.

While international standard forms like FIDIC and JCT provide valuable guidance, Nigerian construction contracts must also address unique local challenges such as economic fluctuations, political instability, and infrastructure constraints. Employing a construction law professional to incorporate provisions for price escalation, currency fluctuation, insurance coverage, and force majeure can help mitigate these risks.

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