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PRESENTS

FIRST AID FOR CONTRACTS

Prevention is Cheaper than Cure

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GCC: GCC 2010 CLAIMS FOR HEAD OFFICE OVERHEADS AND LOSS OF PROFIT – TURNING THE HYPOTHETICAL INTO THE EMPIRICAL

An analysis of how to convert hypothetical overhead costs into proven costs under the GCC 2010

Introduction

An extension of time to the completion date of a project will invariably cause the contractor to incur additional expenses.

One of the heads of claim when seeking the reimbursement of these expenses is a claim for the costs of head office overheads and associated profit.

The contractor's losses arise because it is unable to take on new work, on which it would earn a profit as well as missing out the opportunity to defray these head office overheads by allocating them to another project.

Standard form contracts generally set out the circumstances that entitle the contractor to seek remuneration to cover these losses.

Head Office Overheads and Profit catered for in standard form contracts.

FIDIC

The Fidic Red Book 1999 defines Cost to mean:

"all expenditure reasonably incurred (or to be incurred) by the Contractor, whether on or off Site, including overhead and similar charges, but does not include profit."

Therefore, where an extension of time and additional costs are granted, these costs include an amount for head office overheads and exclude profit.

NEC3

The NEC3 contract makes provisions for the head office overheads costs to form part of the Fee so that where the contractor's costs do not form part of the Defined Cost they are treated as part of the Fee.

JBCC

The JBCC provides for a priced document, which is deemed to include all costs, including overhead and profit.

GCC

The General Conditions of Contract for Civil Engineering Works ("GCC") however does not specifically refer to head office overheads, costs or profit.

The GCC 2004 provides that any claims for additional payment occasioned by an extension of time were to be determined on a basis of "extra cost" and the effect of the extension on the contractor's tendered P&G.

The claims provision in the GCC 2010 has been amended to introduce the concept of "proven additional cost".

The result is that the contactor now has to prove the additional cost resulting from the extension of time should it wish to be successful in its claim when claiming under the GCC 2010.

With this in mind, we deal with the issue of having to prove head office overhead costs and profit which have traditionally been based on hypothetical formulas and not proven costs.

Head Office Overheads and Profit

The management of projects is carried out by people located in the head office. Simply stated, without a head office no contractor could function. However, the head office by itself does not earn revenue as it performs no revenue-generating work. A contractor therefore makes an allowance for this cost in its bid for a job.[1]

The contractor can seek to recoup its head office overhead costs in one of two ways.

The first is as a lost opportunity cost, which is based on the idea that due to the delay, the contractor cannot allocate its head office resources to another project and hence earn the combined cost of the head office overheads and profit.

The second is if additional overhead costs are actually expended as a result of the delay.

Claiming for loss of head office overhead costs and profit under the GCC 2010

Clause 5.12.3 of the GCC 2010 provides that the contractor is entitled to claim for time-related General Items. General Items is defined in the contract to mean items stipulated in the Pricing Data (Bill of Quantities in GCC 2004).

Although SABS 1200A makes provision that a rate for the contractor's head office overheads is intended to be provided for, the Pricing Data in the GCC 2010 does not always call for such a rate.

Therefore in order to claim for head office overheads under the GCC 2010, the contractor has to prove that this additional cost has been incurred.

In the past, formulas[2] have been used to calculate head office overheads where approximate figures were obtained. These formulas have been the subject of scrutiny by the courts in various cases, amongst which is the *Property and Land Contracts LTD v Alfred McAlpine Homes Ltd*[3] case. The court stated that the correct

[1] Loots PC *"Construction Law and Related Issues"* 1995 at page 763.
[2] For example the Hudsons, Emden and Eichleay formulae.
[3] 1995 76 *BLR* 59

approach in assessing head office overhead claims was to ascertain the actual loss or expense incurred and not any hypothetical loss or expense that might have been incurred.[4]

However, the McAlpine case hasn't completely ruled out the use of formula to ascertain the loss of head office overheads but provides a proviso that the court or Arbitrator must satisfy themselves on a balance of probabilities amongst other things that these losses have in fact been sustained.

The requirements were discussed in the case of *Walter Lilly v Mackay*[5] in which Akenhead J gave useful guidance on what is needed to prove head office overhead and loss of profit claims. The court concluded that a contractor:

- Can recover overhead and profit loss as a result of a delay provided the delay contractually entitles it to a claim;
- Must prove on the balance of probabilities that if the delay had not occurred it would have secured new work or projects which it would have produced a return;
- Can use a formula like the Hudson or Emden formula to prove the claim on a balance of probabilities; and
- Does not have to prove the certainty of the costs beyond a reasonable doubt.

As it is in most claims, the difficult part of the claim is producing the evidence to support the claim and as is in most claims, contemporary records play a key role.

In proving its claim for head office overheads and loss of profit in the Walter Lilly case, the contractor furnished the courts with witness statements explaining how the business worked in that it only used directly employed staff and did not hire staff per project; that weekly review meetings of tender opportunities were carried out and tender opportunities accepted or rejected based on staff availability. The contractor also kept records of tenders submitted and jobs won as well as a list of tenders it had declined. The witness statements also listed key employees held up on the project, which resulted in them rejecting certain tender opportunities. The contractor also produced company accounts showing the percentage recovery for head office overheads and profit and expert evidence calculating the weekly loss. The court was able to find that work was available and that the contractor had turned down these opportunities due to the employer's delays and hence had lost a contribution to head office overhead and profit.

The notion of having to prove the loss of head office overheads and profit on a balance of probabilities sits well with the requirements of the GCC 2010 of having to prove additional costs.

Therefore, for a claim for head office overhead costs and loss of profit to be successfully prosecuted under the GCC 2010, evidence of the loss needs to be presented to the adjudicator in a manner that enables him to find that the loss occurred on a balance of probabilities. All appropriate records need to be placed before him so that he can make this ruling. The contractor's records will be vital in establishing this loss and the mere reliance on a hypothetical formula alone will not suffice.

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[4] Bunni NG *The Fidic Forms of Contract* 3ed pg 335.

[5] 2012 EWHV 1773 (TCC)