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SPLITTING CONTRACTS

Where project works include a significant cross-border element it has become common practice for the construction documentation to be split between two or more contracts in order to reduce local tax liabilities. In this article, David Metzger, partner in the Clifford Chance Construction Group, looks at the key legal issues and potential pitfalls associated with such splits.

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Rationale for Splitting Contracts

The usual reason for splitting EPC contracts is to enable the contractor to avoid local corporate taxes on its offshore receipts. The theory is that this should in turn produce a lower overall price for the contract works, provided there is not a significant risk of those receipts being brought onshore for taxation purposes.

In addition, an offshore point of sale for overseas plant, equipment and materials may produce savings for the Employer by the avoidance of onshore indirect taxes such as VAT and other sales taxes. Indeed, in certain jurisdictions it is common practice for there to be further splits of onshore contracts in order to mitigate the incidence of indirect taxes.

In high inflation economies where there is a requirement to use local currency for payments under local construction contracts, creating a separate offshore contract may enable that portion of the project to be paid under a fixed price contract with a harder currency.

A less frequently seen reason for splitting construction contracts is to improve the repayment position of project sponsors. By using a separate project company entity for the offshore contract, it may be possible to alter the basis for sponsors' contributions to the project, enabling these to be categorised as debt and therefore facilitating an easier repatriation of profits than might be available with a straight forward equity contribution. This type of structure is seldom seen unless there are also genuine tax savings to be made, as it will create additional financing complications for the project.

The Classic Split

A diagrammatic representation of a standard split contract structure is set out below (fig.1). The main features are:

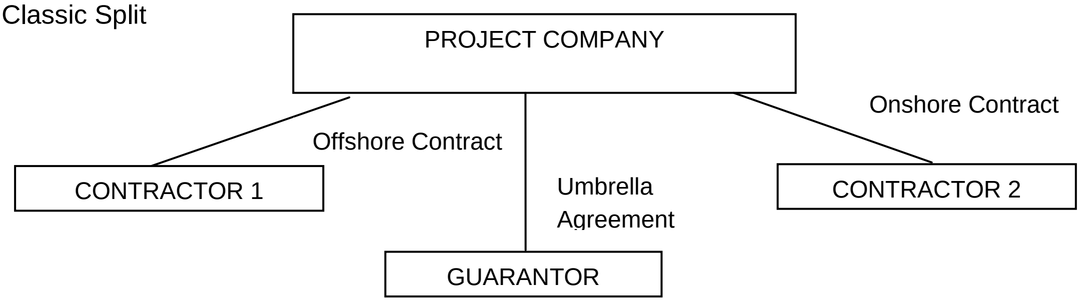
- The EPC contract is split into a separate Offshore and Onshore Contract with different Contractor corporate entities. If the main purpose of the split is to access foreign currency, it may be necessary to also use separate project company vehicles.

- The scope of the Offshore Contract is typically restricted to design, engineering and out-of-country procurement. The Onshore Contract will comprise management of the import process and onward transportation to site of imported goods, onshore procurement and installation, erection, testing, commissioning and other site activities. Consideration will also need to be given to the splitting of obligations to supply training and spare parts, if these are included in the overall scope of supply.

- To ensure there is no derogation from the overall turnkey covenant, there will often be a requirement for an "umbrella" agreement. Umbrella Agreement provisions are commonly used in conjunction with parent company guarantees and are discussed in further detail below.

Figure 1

The Classic Split



Lenders and project sponsors will be keen to ensure that the Project Company's contractual position is not weakened by the splitting process. It is imperative, for example, that one of the Contractors is not able to make claims against the Project Company (for time or money by reason of default of the other Contractor). Similarly, the Contractor should not benefit from defences to claims brought by the Project Company which would not have been available to them had the Contracts not been split.

As a result of these concerns, considerable time is typically spent ensuring that the Project Company is placed in the same contractual position that it would have been in had there been one single contract.

The Primary Rule

Over time, various practices have grown up in order to preserve the Project Company's position. However, it is critical that "standard" solutions are not imposed upon the splitting process. The nature of the split and the legal steps adopted to preserve the Project Company's position must take account of the local tax and legal risks. It is essential that all interested parties have access to (hopefully) clear and unambiguous tax advice setting out the steps that need to be adopted in order to preserve the tax efficient nature of the split and, subsequently, confirming that the legal mechanics put in place in order to preserve the Project Company's position do not create a risk that the tax advantages will be lost.

Stated simply therefore, the Primary Rule is that the regime adopted for splitting construction contracts must be driven by the specific tax circumstances of the deal. Whilst this appears to state the obvious, it is not at all uncommon to see parties attempt to transplant split contract structures from previous deals into different legal and tax jurisdictions where they are simply not appropriate.

Ultimately, one of the parties will be bearing the risk of the additional tax burden in the event that the tax structure does not work (where limited recourse finance is used, this will typically be the Contractor). If there is no confidence that the contractual splitting scheme will work, then the risk of failure will simply be priced back into the project, defeating its purpose.

The Key Contractual Risks

Once tax advice has been obtained setting out the basis on which the construction documentation can be split and the key risks to be avoided, legal steps will need to be taken to preserve the Contractor's covenant to the Project Company. Depending on the nature of any hurdles the tax regime presents, this can become a complex process. However, certain key contractual issues invariably arise:

- Scope of Works - The Project Company and its lenders will be keen to ensure that there are no "gaps" between the scopes of the split Contracts. If separate specifications are produced for each Contract, it is usually perceived that the risk of such gaps arising increases and there will also be a concern that technical inconsistencies between the two specifications may develop. The problem is often mitigated by retaining one project specification and defining the Offshore Contractor's scope by reference to its offshore activities, with the Onshore Contractor responsible for all remaining required activities.

- Warranties - Will separate warranties in respect of each scope provide the same protection as warranties in respect of the whole? If not, will the tax regime permit one of the Contractors to 'wrap' the other or is another solution required?

- Time and Delay Liquidated Damages - Whilst offshore obligations will need to be performed earlier in the piece, it may be difficult to impose time related obligations backed up by a liquidated damages remedy on the performance of the Offshore Contract because of legal restrictions on the enforceability of penalties (particularly where the Contract is governed by English Law). One solution often proposed is that the Onshore Contract contains all the liquidated damages in respect of the cause of delay. However, if the price for the works is largely allocated to the Offshore Contract, certain legal jurisdictions would query the proportionality of delay damages to the Onshore Contract Price. A second solution is for both Contractors to work to the same overall schedule and to share the delay damages burden, if application of the Primary Rule permits.

- Testing Commissioning and Completion - Similar issues arise in relation to the Offshore Contractor's role in relation to the completion regime and any performance testing. It may be necessary for the Onshore Contractor to wrap the completion risk and be responsible for all performance related liquidated damages. Alternatively, the burden may be shared, provided that the Offshore Contractor is expressly bound by the result of tests and certificates.

- Interface Issues - The risk in the offshore supply should transfer seamlessly from the Onshore Contractor; the Project Company should not be left with a marine transit risk. The contractual structure will also need to ensure co-ordination between the Contractors and simplified administrative procedures.

- Cross-Contract Claims - As mentioned above, neither Contractor should be entitled to claim against the Project Company for extensions of time or money by reason of the other Contractor's default. Conversely, it may be necessary to award an extension of time granted on one Contract to the other Contractor, where the latter is taking delay liquidated damages risk, even though its scope of works is unaffected by the delay event.

- Cross-Contract Defences - Similarly, neither Contractor should be able to argue that any claim or set-off against it was caused by the other Contractor.

- Caps on Liability - The Project Company should not be prejudiced by sub-division of any caps on liability in the splitting process. It may be possible to retain overall caps in each Contract and to take account of liabilities incurred under the other Contract. If this cannot be achieved for tax reasons or concerns over legal enforceability, a 'topping-up' regime may be necessary under an Umbrella arrangement (see below).

- Termination - if one Contract is determined (by either party) it is usual for the other to follow suit. Remedies will also need to conform, notwithstanding that there had been no default under one of the Contracts.

Linkage of Contracts

In accordance with the Primary Rule, the solution to the contractual issues identified above will largely be determined by local tax advice. It may be possible under certain tax regimes to place all the contractual risks with one of the Contractors, but considerable care needs to be taken that links between the two Contracts will not result in the loss of the tax benefits created by a split arrangement. In some jurisdictions, cross-default provisions between the split Contracts might create an establishment or an association which brings the offshore receipts onshore. It may not even be appropriate to refer to the existence of the other Contract. Those kinds of restrictions will greatly reduce the ability to deal with the contractual issues identified above in the split Contracts themselves.

A practical solution to deal with outstanding risks arising from the splitting process is the use of an Umbrella Agreement. Often this is incorporated into a parent company guarantee already covering the distinct obligations of the Contractors so as to recreate an effective single point of responsibility.

If in Doubt, Take an Umbrella

The Primary Rule is, of course, equally applicable to an Umbrella Agreement. For example, the participation of the Offshore and Onshore Contractors in the Agreement may not be possible. That said, Umbrella Agreement provisions often include:

- a warranty that the separate scopes of works in the underlying Contracts together provide the overall scope of works for the project. This is to prevent there being any "gaps" between the Contracts;
- a mechanism for identifying (either prospectively or retrospectively) the responsible Contractor for any construction activity;
- if permitted by local tax advice, warranties in respect of the overall scope;
- a mechanism for ensuring that if a cap on liability is reached under one of the split Contracts, the Project Company may draw on any unused caps under the other Contracts;
- administrative procedures, ensuring, for example, that notices need to be given to only one of the Contractors and that the change order process will be dealt with in a co-ordinated manner; and
- mechanisms to ensure that a Contractor cannot avoid liability on the basis that the other Contractor was responsible for that activity.

As the Umbrella Agreement is used to ensure that there are no gaps in the overall Contractor covenant performance, security should be issued in respect of the Umbrella Agreement in addition to the split Contracts.

The Wisdom of Solomon

In conclusion, the splitting of works into separate Contracts always needs to be sensitive to the underlying local tax risks and the drafting complexities of splitting Contracts should not be underestimated.

However, a combination of experienced tax and legal advice should help steer a path to a position which preserves the Project Company's position, whilst at the same time minimising the risk of the tax efficiencies sought not being realised.

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