

Incentivising Subcontractor Performance

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In any large construction project there is likely to be a chain of subcontractors beneath the head contractor, and even the smallest link in that chain may have the power to seriously derail the project schedule. While much focus in any project will be on the big-ticket items, there is a danger that substandard performance by a minor subcontractor could end up leading to significant problems. As the old proverb tells us: *“For want of a nail the shoe was lost. For want of a shoe the horse was lost. For want of a horse the rider was lost. For want of a rider the battle was lost. For want of a battle the kingdom was lost. And all for the want of a nail.”*¹

While the use of liquidated damages will operate (in part) to deter subcontractors from breaching their obligations, there will be situations where the poor performance does not amount to a breach and so does not trigger any liability (whether for liquidated damages or otherwise). There may however be a knock-on effect sufficient to cause the head contractor serious difficulties – for example, the work may become more difficult or time consuming. Contractors will also want to encourage their subcontractors to contribute positively to the project (such as to reduce time and cost), while producing the highest quality work, rather than the minimum sufficient to comply with their contractual obligations.

This article will look at methods for incentivising subcontractors to perform where there is not otherwise an actionable breach of contract. That could include a failure by a subcontractor to provide certain documents needed in order for the contractor to begin work, or consistently supplying products/completing work at the last possible moment. It will also consider how to encourage performance at a level better than the bare minimum.

The Carrot or the Stick?

Incentives can be positive or negative, encouraging optimal performance either through the desire for greater financial reward or through concerns about exposure to liability. While the traditional approach may have erred towards negative incentives, studies tend to indicate that the exclusive use of such methods can in fact end up having a detrimental effect on performance. For example, it may hinder the development of a collaborative relationship between the parties and end up creating a toxic and unproductive working environment. Similarly, the sole use of bonuses and other such positive incentives can result in a subcontractor who becomes difficult to control and whose expectations may not be realistic in the event of a market downturn. As such, a judicious use of both styles is likely to have the most success. Indeed, a subcontractor will be more willing to take on the risk of painful consequences for poor performance, if it will also be rewarded for performing well.

While this sounds simple in principle, creating a contractual mechanism that puts it into practice can be more difficult. There are a number of key issues: (1) the nature of the incentives themselves; (2) how performance is measured (and by whom); (3) when performance is measured; and (4) if failures can be rectified.

The Incentives

Any provision for incentives – and whether they are financial or non-financial – must be clearly drafted and properly incorporated into the agreement between the parties.

Liquidated damages are commonplace where the completion of works are delayed and they can also be applied where the sub-contractor guarantees the technical performance of equipment. However, as indicated above, they are intended to operate in the event of a breach and so will not assist where the aim is to improve performance beyond the baseline required under the contract. Under English law, recent (Supreme Court) authority has made it clear that such provisions are enforceable if the party enforcing payment has a legitimate interest in ensuring performance by the other and the amount to be paid is not out of all proportion in the circumstances. In the context of construction contracts concluded between commercial entities, this test is likely to be met in most circumstances.

Parties are generally free to provide for positive incentives in whatever manner they wish. A bonus structure for meeting of targets above a certain level, for example, may be used. Such a bonus structure may represent a small increase in expense in terms of the value of the whole project but may have a dramatic effect on performance. However, and as dealt with in more detail below, any related targets must be measurable (for example quantities of work produced within a given time period, or hours of work to complete a certain milestone).

Other possibilities for positive and negative incentives could include:

- With a repeat subcontractor, there could be a provision for service credits if targets are not met (for example, a discount on the next order if milestones are missed);
- An annual “best subcontractor award” or “preferred subcontractor” status, leading to a promise of right of first refusal for future contracts; and
- A graduated, tiered provision for increased profits for excellent performance.

Whether or not such provisions will be appropriate will depend on the nature of the particular project and the work being carried out by the relevant subcontractor. For example, if a subcontractor is regularly used to provide particular items of equipment for use on projects by way of rental agreements, the idea of a discount on the next order if targets are not met might be a useful approach. This may be particularly appropriate where there are no, or limited, alternative providers meaning that a threat of moving to a competitor cannot be made.

Measuring Performance

Possible methods to measure performance must be SMART – specific, measurable, achievable, realistic and timely (i.e. incorporating a point in time when reached). Benchmarking will be essential, though the precise details of such benchmarks are likely to be project specific (for example these could include dates for delivery of certain components or documents, quality control targets or response times). The contract must be clear in setting out which party is responsible for capturing and reporting the relevant data used in the assessment and at what intervals. A template can be used to record the relevant data the form of which should be prescribed within the contractual documents. Reporting and assessing performance in this way at regular intervals – as opposed to the use of end targets – will also assist generally in managing the project: potential problems and risk areas are much more likely to be identified earlier increasing the chance that they may be resolved before they have a negative impact.

It may be advisable to include a “performance target table” in the contract, and specify that, if a target is met, then a bonus will be received but, if not, then there will be a negative consequence. This will allow a contractor to ensure that events which are important to it, but do not explicitly affect

the main contract (such as delivery of certain papers or certificates), are provided for. The table would set out details of such targets (including, for example, those relating to quality where appropriate), time frames and opportunities for assessment and discussion of progress. In order to avoid fear from the subcontractor that such arrangements will be unfair, the interface matrix setting out such discussions should be detailed and provide for regular meetings of key individuals, as well as less regular ones involving those higher up the management chain. It is important, however, to be careful with time related targets that simply encourage a subcontractor to rush performance with a subsequent reduction in quality. It is therefore advisable to include targets relating to both elements of performance in any such set of goals. However, the precise specifics and nature of any such table will be entirely project dependent and should be designed with both the work itself and the capabilities of the individual subcontractor in mind.

Putting Things Right

It is key that any subcontractor feels it has the ability to put right any issues in performance, in particular to avoid it simply giving up once negative incentives have been triggered. As such it is advisable to provide for a rectification period in the contract to allow the subcontractor to avoid in whole or in part the effects of the negative incentive. Ideally, the contractor should provide written notice that performance is not satisfactory and provide for a set period for this to be rectified. This could then trigger a compulsory meeting to discuss how best to fix the problem. Smooth channels of communication up and down the subcontractor/contractor chain will, as always, be of key importance. As is set out above, the use of regular meetings will help to ensure problems can be spotted and potentially rectified as early as possible.

Conclusions

It is vital that any contractual incentivisation is discussed with the relevant subcontractors before being put in place. Each relationship will be unique, as will the demands of each industry. It is important that a contractor takes time to understand the cost drivers of its subcontractors, as well as the potential impacts on their ability to perform. Indeed, it may be that asking subcontractors how they think they can best be incentivised may lead to beneficial solutions for both sides. This should be a discussion that subcontractors will welcome given that it potentially offers the chance for them to earn more and strengthen the relationship. Focussing on the positives of such a structure for the subcontractors is crucial and may help ensure that lost nails do not cost you a kingdom.

¹ An interesting version of this saying can be found in English case law in *British Columbia Saw-Mill Co. v. Nettleship* (1868): “Cases of this kind have always been found to be very difficult to deal with, beginning with a case said to have been decided about two centuries and a half ago, where a man going to be married to an heiress, his horse having cast a shoe on the journey, employed a blacksmith to replace it, who did the work so unskilfully that the horse was lamed, and, the rider not arriving in time, the lady married another; and the blacksmith was held liable for the loss of the marriage.”