

OUTSOURCING IN THE CONSTRUCTION INDUSTRY

Prepared by
Karim H. Mahmud
Partner
Fraser Milner Casgrain LLP

September, 2008

Montréal
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Outsourcing in the Construction Industry

While outsourcing is not a novel concept for many business organizations, we have noted that it is increasingly being used by clients in the construction sector and is impacting the planning, procurement and implementation of major construction projects.

Traditionally, back office functions like accounting, payroll and other routine administrative tasks have been outsourced to third party service providers in Canada or abroad. The key impetus that drives outsourcing tends to be cost reduction and the efficient allocation of resources. Space, personnel and other resources devoted to routine and reasonably predictable tasks need not be located in head offices in locales with high rents and tight labour supply.

Given that spiralling costs have plagued the construction industry over the recent past, it is not surprising that we are seeing clients who are operating large construction projects also examine the outsourcing tool as a means to reduce construction project costs.

While construction operations may indirectly benefit from outsourcing in a large company in areas such as accounting or supply chain management software, this article will examine a few examples of outsourcing that directly impact construction operations.

The Use of Mandatory Suppliers

It is not unusual for owners of large construction projects to require construction contractors at a specific construction site/project to obtain or purchase identified supplies or services from owner specified mandatory suppliers. The logic that drives this approach by owners is to identify areas where volume acquisition of supplies or services will result in material cost savings for an owner across a project rather than procuring the same piecemeal on a per contradict basis. While this form of outsourcing has been common in certain parts of large projects such as camp operations and travel management, it is now being introduced into areas that more directly impact construction operations including construction supplies and consumables as well as owner supplied goods and services such as scaffolding and certain types of heavy equipment (e.g. cranes).

In contracts with construction contractors requiring the use of such mandatory suppliers, certain owners are willing to accept a degree of responsibility for the performance of such mandatory suppliers by extending the definition of "owner" under such agreement to include mandatory suppliers in certain circumstances, allowing for contract change orders in the event of non excusable delays, and/or allowing construction contractors to obtain alternative supplies or services in defined circumstances at owners costs where mandatory suppliers are unable to perform.

Other owners are less willing to accept responsibility for the performance of mandatory suppliers. This is notwithstanding the fact that the owner is requiring the use of such mandatory suppliers. This approach by owners can cause contract implementation issues in certain

circumstances including non performance of mandatory suppliers or force majeure as the construction contractor does not have privity of contract with a mandatory supplier and has limited or no rights of recourse with the owner. In our experience, it is generally in both parties' interests for the owner to accept a reasonable degree of responsibility for the performance of mandatory suppliers.

The mandatory supplier concept is already being extended into new areas. Recently, we have seen owners not only require the use of mandatory suppliers but also owner attempts to engage in the financing and manufacture of mandatory supplies for products that are in acute short supply now and in the foreseeable future. To date this has generally applied to important consumables. While not common, should this trend continue, interesting legal issues may arise with respect to issues such as defective product manufacture. For example, if a consumable that is manufactured by the owner and obtained from a mandatory supplier fails to perform and is found defective, will the owner (as owner of a construction project) be placed in the awkward situation where it may need to consider pursuing legal remedies against itself (as manufacturer of the defective product)?.

Owner Obligation Outsourcing

Another emerging area is the outsourcing of entire business lines by companies in the energy sector. This goes beyond owner subcontracting of certain tasks it has traditionally performed, to the wholesale outsourcing by owner of operational departments or divisions to third parties. An example is the outsourcing of all maintenance operations to third parties by owners. The obvious impact of this on construction contractors is the introduction of an additional party to the owner-contractor relationship to perform certain owner-required tasks under a construction contract. Complicating matters is that such third party is often very well integrated into owner operations to the extent that the construction contractor may be unaware that they are technically dealing with a third party and not the owner. Construction contractors therefore need to carefully consider owner responsibilities under construction contracts and confirm with the owner the extent to which the owner will be outsourcing owner responsibilities under such contract to third parties. Outsourcing of maintenance operations may also impact the exercise of owner rights in areas such as warranty and re-work provisions (including possible owner reserved rights to self repair). The crux of this issue is the fact that such outsourced entity is likely going to be a third party vis a vis the construction contractor and, in the absence of privity of contract between the construction contractor and the outsourced entity, liability for non- or mal- performance of owner obligations under the subject construction contract should be clearly addressed in the subject contract. In addition, indemnity and insurance provisions need to be carefully considered. This may be alleviated by using various methods including explicit language making the owner responsible for the performance of its outsourcing contractors, although, as previously mentioned, certain owners are reluctant to accept a reasonable degree of responsibility for outsourced activities.

Conclusion

We would expect the trend of outsourcing in the construction industry to continue. Its application to new areas will likely be tested as the degree to which some owners are requiring the use of outsourced entities while trying to absolve responsibility for the same strains the boundaries of reasonableness. This is an area which we will continue to monitor with interest and report back on from time to time.

MONTREAL

1 Place Ville-Marie
Suite 3900
Montréal, QC H3B 4M7
Tel (514) 878-8800
Fax (514) 866-2241

OTTAWA

Suite 1420
99 Bank Street
Ottawa, ON K1P 1H4
Tel (613) 783-9600
Fax (613) 783-9690

TORONTO

1 First Canadian Place
100 King Street West
Toronto, ON M5X 1B2
Tel (416) 863-4511
Fax (416) 863-4592

EDMONTON

2900 Manulife Place
10180 - 101 Street
Edmonton, AB T5J 3V5
Tel (780) 423-7100
Fax (780) 423-7276

CALGARY

30th Floor, Fifth Avenue Place
237 - 4th Avenue SW
Calgary, AB T2P 4X7
Tel (403) 268-7000
Fax (403) 268-3100

VANCOUVER

15th Floor
The Grosvenor Building
1040 West Georgia Street
Vancouver, BC V6E 4H8
Tel (604) 687-4460
Fax (604) 683-5214

NEW YORK

Suite 1528
One Rockefeller Plaza
New York, NY 10020
Tel (212) 218-2995
Fax (212) 218-2972



FRASER MILNER CASGRAIN LLP

www.fmc-law.com