



Eteläranta 4 B 9
00130 Helsinki, Finland
Tel. +358 9 696207-0
Fax +358 9 696207-10
helsinki@bjl-legal.com

International Industrial Plant Construction Contracts in Finland

Back-to-back clauses and compulsory law

As a rule, industrial plant contracts are agreed on a turnkey basis. For building the industrial plant the general contractor has to use a variety of subcontractors from different branches and of different nationalities. The special characteristics of international industrial projects present a challenge also in the process of contract drafting. Back-to-back clauses are often used in order to cope with this challenge. However, they are not a magic wand.

by

Hans Bergmann

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1. Subcontractor agreements between national and international operations

The owner of the industrial plant, as well as the plant builder, may come from abroad as an international investor, or might also be a local Finnish company. What makes plant building an international branch is that from the point of view of the plant builder the project as a rule is carried out abroad, and a considerable number of the subcontracts are awarded to local subcontractors. The price per kilogram of the merchandise plays a decisive role in this regard: if the price per kilogram is low, foreign sellers are not able to compete due to the extra costs of transport.

In construction, the international bidder has no chance to compensate for high transport costs by using construction workers from low wage countries: insofar as the works are carried out in Finland, Finnish conditions regarding wages and work time as agreed in the respective collective works agreements have to be complied with. Where turnkey building is concerned this means

that the foreign plant builder has to use local suppliers for at least part of the construction and infrastructure works in order to make a competitive bid for the plant contract.

2. Back-to-back clauses: the target but not the way

2.1. Back-to-back clauses as a specific risk in subcontracts

Back-to-back clauses are used in subcontracts for making the main agreement, or portions thereof, an integral part of the subcontract by including in the subcontract a reference to the main agreement. In theory, the idea is that if the sub-supplier is obliged to fulfil the same works, which are to be done under the main agreement, then the profit would be the difference between the received and the paid price. In practice, however, the formula does not always work out. Back-to-back clauses are often used for describing the scope of the contractual works or other major conditions of the agreement as the acceptance procedure, the warranty obligations, or the consequences

of delayed performance. Where disputes arise, however, the interpretation of back-to-back clauses often leads to more questions than answers.

2.2. Common interests regarding critical supplies

Not all subcontractor supplies are critical to the same degree in respect of the completion of the plant in due time and to the agreed quality. Many subcontractor supplies have no immediate impact on contractual milestones for which penalties may be imposed in cases of delay under the main contract. This matter must be evaluated on a case-by-case basis. With regard to supplies on the critical time path however the customer is typically in the same boat with the supplier.

The capacity of a subcontractor should not be assumed on overly optimistic grounds, as only in exceptional cases do back-to-back clauses ensure that the general contractor is completely covered for all damage if the plant is not completed in due time or to the agreed quality. Irrespective of any contractual clauses, the delay in



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the project does not represent a problem only for the party causing the delay. It also causes a problem for all buyers up to the plant owner, which suffer substantial loss, if the plant is not ready for operation as agreed.

Where completion of the plant is delayed, the owner suffers loss of production and supply capacity, which can lead to enormous consequential damage. As a rule, the agreement between owner and plant builder does not provide for compensation for such consequential damage. The agreed penalties for delay or possible price-reduction resulting from faulty supply are in general agreed as a certain percentage of the financial value of each contract, and therefore the compensation is usually insufficient to cover the full damage suffered by the owner. Personal liability towards the relevant purchaser, throughout the entire delivery chain, is considerably higher than the compensation that may be sought from the subcontractor responsible for causing the problem.

Of course, if one or other of the subcontractors were ready to accept unlimited liability the liability gap described above would be covered. However, contract clauses to this effect would in many cases be considered unfair – and thus invalid – especially if they are agreed in a variety of sub-supply contracts as general business conditions. Anyhow, most of the subcontractors are small or medium-sized enterprises, which are economically not in a position to pay damages which may exceed

their own contract value by a large margin.

It is not reasonable to impose obligations on subcontractors which exceed their capacity to meet them.

2.3. Typology of back-to-back clauses

The traditional scope of application of back-to-back clauses is the definition of the contractual works. Even here, in the core area of the clause, the general contractor may be hit by unpleasant surprises.

Typically, the completion clause is agreed and the plant builder is obliged to fulfil all deliveries and services which are necessary to complete the industrial plant as agreed, even where certain deliveries or services are not listed in the contractual mass lists. The completion risk cannot 1:1 be endorsed by the general contractor to its subcontractors: only the plant builder knows which deliveries and services it will itself provide, which deliveries and services are to be ordered from subcontractors and, in particular, whether or not all partial supplies and deliveries will in aggregate amount to what was agreed in the contract.

Equally as popular as back-to-back work scope clauses are back-to-back liability and warranty clauses, in respect of which the relevant original stipulations in the main contract are usually negotiated in detail between the owner and the plant builder. Therefore, these are legally valid contract terms even if they differ markedly from the correspond-

ing concepts of statutory law. In legal terms, the situation changes dramatically once the terms are incorporated back-to-back into a variety of subcontracts. The clauses then become general contract conditions by dint of repeated application, and as such they are subject to strict contents control. The same clauses, which are valid as part of the main contract, are often invalid as part of subcontracts.

The use of back-to-back clauses is tempting to such degree that they are used in practice in all kinds of situations, some of which are viable and others not. For example, one could mention a draft contract for an industrial plant on the basis of a model agreement which had been used between the owner and plant builder of the same nationality in earlier cases. As the project took place abroad it was obvious that many subcontracts would – in contrast to cases in earlier national projects – have to be agreed in accordance with the provisions of foreign law, which could obviously have implications with regard to the back-to-back clauses used in such subcontractor agreements. The draft agreement stipulated that there should be a clause according to which the owner should carry the risk of the application of foreign national law. Such back-to-back clauses do not help to achieve the desired results at all. From a juridical point of view the application of a foreign law does not constitute a risk. It is a fundamental principle in western legal systems that the parties may freely agree on their contracts, even though foreign law applies to their contract. The



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parties can agree what they want to agree and can exclude what they do not want to agree. If the result does not reflect the intentions of the parties this is not the consequence of the risk of a foreign law, but rather the avoidable result of poor contract design and drafting.

In my professional experience, back-to-back clauses fail more often than they meet the expectations of the parties. Due to the different facts of each case the same contract clause in the main agreement often leads to a different result as a part of the sub-supply contract. Examples of this include the following:

- Time limits which are calculated from the date of signature of the contract or from the completion of the delivery, because the main agreement and sub-supply agreement are concluded and carried out during different phases of the project.
- Rights and obligations regarding planning, organization and instructions on site, as the main purpose of such competence is to minimize possible conflicts between the subcontractors. The aim of minimizing conflict can only be achieved if the general contractor acts on the basis of contractually agreed instruction rights, to which all subcontractors have agreed in their respective agreements.
- Reference values which are set as fixed amounts in the main agreement, for example in connection with

contractual penalties or in connection with the delay of the owner in making agreed payments as a condition for termination or hold-back rights of the contractor. Under the subcontract it might not even be possible to achieve such values.

- Pre-emptive national law, which has to be complied with on site, because such pre-emptive national law might not be binding in relation to the international agreement between the owner and general contractor, but would be binding as applied to the subcontractor agreements.
- Procedures for testing and acceptance of the main agreement, as such procedures are not suited to partial supplies
- The resolution of claims in court, because the demands for proof of faulty supply or service may be different in the case of complete supply obligations on the one hand and partial supply obligations on the other.

Well-designed back-to-back clauses have their place even in the future. However, unless such clauses are formulated with the necessary precision, they may easily cause serious harm.

Insofar as national law requires pre-emptive compliance it also indicates, at the same time the cases in which the provision applies. Proximity to the national market plays a decisive role for the application of such pre-emptive law. For sub-supply agree-

ments with local companies there is a higher risk that compulsory Finnish law will apply.

3. Choice of law and structure of contracts: legal and economic factors

In principle, it is possible to agree that foreign law will govern a contractual relationship instead of Finnish law if there is any acceptable interest for a choice of law. In the case of international industrial plant-building such interest is obvious, even if both partners are Finnish companies and the works would have to be carried out locally in Finland. To justify the choice of law it is considered sufficient that the buyer is itself bound by contract under foreign law. The need to pass on the own contractual obligation to one's sub-suppliers in the supply chain is always considered a legitimate reason for a choice of law clause.

Complications are very likely to arise if different national laws apply to contracts which are tied to each other by a back-to-back clause. Of course, those provisions which are part of the contract text itself will apply back-to-back. The contract provisions will, however, be interpreted on the basis of different legal concepts. This leads to different results not only in theory. Furthermore, in continental European contract culture, provisions of the applicable national law are invoked with regard to issues not expressly dealt with the contract text, as well as in connection with contractual terms which demand more concrete determination. The contract might provide, for



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example, conditions to determine whether or not the owner is in delay with payment or liable for default interest. The default interest rate is, however, often left to the provisions of the national law. The contract might also provide for termination if the other party is in breach of important contractual duties. The duties that may be considered important in this regard can, as a rule, only be defined on the basis of the applicable law and relevant court practice. The interpretation of the contract may differ according to the law under which the contract is interpreted and completed with regards to gaps and general contract terms.

Commercial implications of back-to-back clauses

The purchase of local construction services under contracts construed under foreign law is usually only possible against considerable price increases. Where national sub-suppliers are requested to give their bid offers for contracts under foreign law, they will make considerable increases for risk in their prices. These risks might not even exist, but the sub-supplier does not know that this is the case. This means that the purchases will become unnecessarily expensive for the purchaser.

The main contractor can often make considerable savings on the expenses involved in concluding local sub-supply contracts by agreeing on the contractual conditions commonly in use in Finland. Bidders for the provision of construction services need to acquaint themselves with the conditions of YSE (General

conditions for construction services). International plant builders should give consideration to whether a unit price agreement is the right choice. In Finnish praxis target price agreements or fixed price agreements are at least as popular as unit price agreements. Consequently, a unit price agreement might not always be the best choice.

4. Collateral

Whether or not certain types of collateral are valid in case of the bankruptcy of the purchaser is determined in accordance with the law of the country in which the bankruptcy proceedings occur. This applies irrespective of which law otherwise governs the contractual relationship between the parties.

If one has delivered construction goods or merchandise to Finland with an agreed retention of title clause it is highly likely that this clause will be ineffective. According to Finnish law construction goods become the property of the buyer at the latest when they are delivered to the site. In the case of a transfer of receivables against a third party domiciled in Finland, the transfer is not effective if it is not indicated to the third party prior to commencement of bankruptcy proceedings. Identical back-to-back agreements regarding collateral for the down payment, the fulfilment of the contract, or for the purchase price, may be effective between the owner and the main supplier, and ineffective between the main supplier and its sub-suppliers, depending on the domicile of the debtor of the transferred re-

ceivables or on the location of the goods in question.

With regard to bank guarantees, it might be a decisive advantage to the debtor if he or she manages to acquire a preliminary stop payment order from the local court by claiming that the payment demand under the guarantee represents a misuse of rights. The court where the guaranteeing bank is domiciled will be the competent court for such a preliminary procedure. The level of proof required to establish misuse of rights differs from country to country. Therefore, even identical wording of the guarantees does not always provide the same position in enforcing rights if the guaranteeing banks are in each case domiciled in different countries.

5. Public licences: easiest solution is not always the best

The timely issue of public licences, for example,

- for landscaping measures, mobilization of the site and waste disposal procedures;
- for import and transport licences which may possibly be required; or
- for the storage and handling of dangerous goods

has a direct influence on the time schedule of the project.

The time required for the licence procedure naturally differs depending on the relevant procedure and competent authority. It is not reasonable to make any assumptions on this issue based on experiences in one's home coun-

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try. Neither it is reasonable to shift the responsibility for licence procedures to sub-suppliers on a general basis. One cannot carry out a great deal of work until the site is landscaped and mobilized, and the import, transport and storage of goods is secured. The general contractor has every reason to consider independently such issues as which licences will be needed, how much time needs to be reserved, and what are the most effective ways in which to carry out the procedures.

Various different issues have a bearing on such questions:

- Often the party who has the best technical know-how will also be in a position to prepare application procedures effectively.
- On the other hand, in practice it may be of assistance in going through the procedures if a local company acts as applicant.
- The applicable public law may restrict the group of possible applicants.
- Some licences can be applied for by way of a simplified procedure if the applicant already holds certain general licences. General operation licences often include licences for transport and storage of dangerous goods, whereas an applicant not holding an operation licence would have to run through the full procedure.
- In order to protect business secrets one will often have an interest in the central-

ised handling of applications.

The above aspects may sometimes point in different directions. The most effective solution may involve tailored division of responsibilities in which the internal responsibility may fall on one party and the external position of the applicant on another party.

6. Organization of the site: responsibility for supervision of the subcontractors

In the field of employment law, the party responsible for the management of the site, which is usually the main contractor, has to comply with a variety of pre-emptive legal requirements. Such obligations are connected with matters ranging from healthcare to general work security. In addition, the main contractor employing subcontractors without business premises in Finland has to comply with notice and supervision obligations regarding the conditions of employment contracts of foreign employees as well as work permit procedures. Violating these legal requirements constitutes a criminal act for which the manager responsible can be punished. The use of back-to-back clauses in order to shift such liabilities to the subcontractors would be ineffective if, for example, the work permit procedures are not complied with. Supervision and reporting obligations are required from the main contractor in Finland because the Finnish authorities have no possibility of enforcing their control abroad. It is therefore obvious that attempting to shift reporting obligations

to a foreign party would not be acceptable.

7. Price adjustment clauses: Finnish law makes the use of back-to-back clauses tricky

The use of price adjustment clauses is indispensable in international plant construction, which often demands a period of one to five years for completion. As a general rule price adjustment clauses are not permitted in Finland.

An exceptional permission for price adjustment clauses may be granted in the case of international agreements, but it has been stated in the respective Governmental Bills– if both parties to the contract have business premises in Finland – the contract will no longer be considered international. As the main contractor has business premises in Finland, it follows that if works are planned to take longer than twelve months it might not be possible to agree the price adjustment with local sub-suppliers.

There is another exceptional point for price adjustment where construction contracts of a duration of more than twelve months are concerned. This exception is, however, very restricted as to the type and degree of indexation permitted in each case. One would have to draft different clauses depending on the specific subjects of the supply. Taking a price adjustment clause back-to-back from the main contract to sub-supply contracts would probably result in invalid clauses.



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Under paragraph 4 of the Finnish Indexation Act it is possible to apply for a permit to use certain index clauses in a certain contract or number of contracts. Applying for such a permit might be a good idea if there is any uncertainty about the validity of the envisaged index clause.

8. Litigation procedures: the home advantage should not be overestimated

In civil law procedures the parties are free to agree on the competence of the national courts of a foreign country or of arbitration courts.

In this connection, the taking into account of back-to-back aspects might provide a considerable advantage. Tying up the possible litigation between the customer, on the one hand, and the sub-suppliers on the other hand, could ensure that the sub-suppliers cannot question the results achieved in litigation between the main contractor and the owner.

It is often the case that potential synergy remains unused because the 'home advantage' is given preference whenever the other party is willing to accept a forum clause. This is not always advisable. Litigation procedures in connection with industrial plant projects are often complex and involve high economical interest. These procedures require correspondingly large resources. The major part of the litigation costs and work is connected with the written pleadings of the parties. Whereas litigation is sometimes pursued for years, the hearing often takes a day only. The home advantage of having the compe-

tent court in one's home country – at least in the case of arbitration procedures – does not provide any further benefit than that one does not have to travel for this one hearing.