

# UNABSORBED HEAD OFFICE OVERHEADS: PROVE IT



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This article addresses what the author believes is a commonly ignored, yet critical, aspect of claims for unabsorbed head office overheads; the claimant's obligation to prove that head office overheads have been unabsorbed.

To fully address the issue of unabsorbed head office overheads, the article first discusses delay in terms of criticality, excusability and compensability, and prolongation costs before focusing on the main subject of unabsorbed head office overheads.

The author hopes this article will provide contractors and employers with a point of reference when preparing, assessing/rebutting and settling claims for unabsorbed head office overheads.

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## Criticality, Excusability and Compensability

Typically, an extension of time claim is accompanied or followed by a cost claim, the purpose of which is to recover the additional costs incurred as a consequence of performing work beyond the contractual completion date. Collectively, these costs are referred to as prolongation costs and a contractor's ability to recover them requires three things.

Firstly, a contractor must show that the cause of delay impacted the critical path of the programme i.e. caused critical delay. Without the occurrence of critical delay, a contractor cannot assert that the completion date was impacted, thus a claim for prolongation costs cannot be made.

Secondly, the cause of the delay must be one which is excusable under the contract, subject to either an express or implied term. An example of such an express term is found at Sub-Clause 8.5 of the Federation of Consulting Engineers Conditions of Contract for Construction, more commonly known as the Red Book, which states that, among other things, variations are excusable causes of delay.<sup>1</sup> With regards implied terms, in some civil law jurisdictions, a term will be deemed implied if it is established that the parties had agreed for it to be included but did not expressly include it in the contract.

<sup>1</sup> Federation of Consulting Engineers Conditions of Contract for Construction, Second Edition 2017.

Thirdly, the cause of the delay must be one which is compensable meaning the prolongation costs incurred by the contractor will be borne by the employer. As with an excusable cause of delay, compensability is also subject to express or implied terms.

It should be noted that not all excusable causes of delay are compensable. An example can be found at Sub-Clause 18.4 of the Red Book which states that a delay caused by the occurrence of a natural catastrophe is not compensable.<sup>2</sup>

## Prolongation Costs

In practice, a contractor will claim prolongation costs under a number of categories, more commonly known as heads of claim. These categories include indirect staff, bonds and insurances, site accommodation, bank finance charges, utilities, unabsorbed head office overheads and loss of profit.

The purpose of paying prolongation costs to the contractor is to return it, as close as possible, to the financial position it could reasonably have expected to be in had the delay not occurred. Thus, the amount paid should be equal to the cost incurred. In *Alfred McAlpine v PLC*, HHJ Humphrey Lloyd QC stated, “*the actual loss or expense incurred by the contractor must be ascertained and not any hypothetical loss or expense that might have been incurred*”.<sup>3</sup> In other words, before a contractor can assert entitlement to prolongation costs, it must prove that actual loss has been suffered and to what extent.

It should be noted that quantification of prolongation costs is not as straight forward as demonstrating the cost incurred. There are several factors which may have a bearing on the amount of prolongation costs that can be recovered including the test for remoteness, the existence of concurrency and whether or not a contractor took steps to mitigate the costs being incurred.

## Head Office Overheads

Head office overheads are those costs incurred by a contractor due to its existence as a business, such as office based staff salaries, consumables, utilities and insurance of company cars. To recover these costs, the contractor will include an amount for head office overheads (in addition to labour, plant, material and profit) within its tender prices to ensure that each project contributes to the recovery of head office overheads.

When a project is no longer able to contribute to head office overheads, it can be said that head office overheads are being unabsorbed. Keating on Building Contracts provides the following explanation:

*“A contractor’s overheads are commonly taken to be recovered out of the income from his business as a whole and ordinarily where completion of one contract is delayed the contractor claims to have suffered a loss arising from the diminution of his income from the job and hence the turnover of his business. But he continues to incur expenditure on overheads which he cannot materially reduce or, in respect of the site, can only reduce, if at all, to a limited extent. But for the delay, the workforce would have had the opportunity of being employed on another contract which would have had the effect of contributing to the overheads during the overrun period.”<sup>4</sup>*

2 Federation of Consulting Engineers Conditions of Contract for Construction, Second Edition 2017.  
3 *Alfred McAlpine Homes North Ltd v Property and Land Contractors Ltd* (1995) 76 BLR 59.  
4 Page 229, Keating on Construction Contracts, 6th edition.

If you consider the enormity of the largest contractor's in existence today, what is required behind the scenes to keep them in operation and the duration of the mega projects being performed all over the world, it stands to reason that a long enough delay could result in claims for massive amounts of unabsorbed head office overheads. Thus, it would be reasonable to expect contractors to make the same effort calculating unabsorbed head office overheads that they do when calculating costs incurred under other heads of claim such as indirect staff costs. However, it can be said with a significant level of confidence that this is not the case.



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## Entitlement and Quantification

In disregard for the need to prove that a loss has been suffered and to what extent, claims for unabsorbed head office overheads will rarely attempt to do so. Instead, contractors will usually presume that entitlement to unabsorbed head office overheads exists and apply a formula (e.g. Hudson, Emden or Eichleay) to calculate the notional loss.

This is due to the fact that it is significantly harder to demonstrate entitlement to unabsorbed head office overheads when compared to other heads of claim such as indirect staff costs. Quantification of the other heads of claim using actual costs serves a dual purpose - it establishes the extent of the actual loss suffered and thus entitlement because a loss has been suffered. However, the same is not typically possible for unabsorbed head office overheads.

In acknowledgment of this, in *Walter Lilly v Mackay*, one of the leading cases in modern times with regards unabsorbed head office overheads, The Hon. Mr. Justice Akenhead stated:

*“It is necessary for the contractor to prove on a balance of probabilities that if the delay had not occurred it would have secured work or projects which would have produced a return (over and above costs) representing a profit and/or a contribution to head office overheads.”<sup>5</sup>*

5 Para. 543, *Walter Lilly & Company Limited v Giles Patrick Cyril Mackay and DMW Developments Limited* [2012] EWHC 1773 (TCC).

The view of The Hon. Mr. Justice Akenhead is reiterated in the SCL Protocol. It states:

*“Before it can recover unabsorbed overheads and lost profit, the Contractor must be able to demonstrate that it has:*

- (a) failed to recover the overheads and earn the profit it could reasonably have expected during the period of prolongation; and*
- (b) been unable to recover such overheads and earn such profit because its resources were tied up by Employer Risk Events.<sup>6</sup>*

*In order to succeed in such a claim, the Contractor must demonstrate that there was other revenue and profit earning work available which, in the absence of the Employer Delay, would have been secured by the Contractor.”<sup>7</sup>*

Unfortunately, demonstrating this is easier in theory than in practice. However, the SCL Protocol provides guidance on what can be done to demonstrate that head office overheads have been unabsorbed:

*“If the Contractor intends to rely on the application of a formula for the assessment of lost profits and unabsorbed head office overheads, it will first need to produce evidence that it was unable to undertake other work that was available to it because of the Employer Delay. These records may include the Contractor’s business plans prior to the Employer Delay, the Contractor’s tendering history and records of acceptance or rejection of tender opportunities depending upon resource availability. Also relevant will be minutes of any meetings to review future tendering opportunities and staff availability.”<sup>8</sup>*

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Keating on Building Contracts reiterates the SCL Protocol’s suggestion in a plainer form, simply stating that unabsorbed head office overheads could be proven by a contractor if it can “show from the accounts a drop in turnover and establish that this resulted from the particular delay rather than from extraneous causes.”<sup>9</sup>

## Conclusion

Once a contractor has proven that critical delay has occurred, the cause of which is excusable and compensable as per the express and implied terms of the contract, it may consider submitting a cost claim to recover its prolongation costs.

When it comes to unabsorbed head office overheads, contractors should heed the suggestion of The Hon. Mr. Justice Akenhead. Only after a contractor has proven that head office overheads have been unabsorbed on a balance of probabilities rather than definitively, should its attention turn to the quantification. After all, until proven, no entitlement to recover unabsorbed head office overheads exists.

It is of vital importance to the proper and accurate preparation, assessment and settlement of claims that employers and contractors understand that the use of a formula does not establish entitlement to recover unabsorbed head office overheads. If both understand and accept this, time and effort debating the matter can be reduced and unnecessary payment against such claims can be avoided.

6 Para. 2.6 of the Society of Construction Law Delay and Disruption Protocol 2nd Edition February 2017.

7 Para. 2.7 of the Society of Construction Law Delay and Disruption Protocol 2nd Edition February 2017.

8 Para. 1.28 of the Society of Construction Law Delay and Disruption Protocol 2nd Edition February 2017.

9 Para. 9-053 of Keating on Construction Contracts Tenth Edition.