IMPROVING PAYMENT PRACTICES IN THE CONSTRUCTION INDUSTRY

Report of the DTI's post-consultation event held in London on 14th February 2006

On Valentine's Day 2006, the Right Honourable Alun Michael MP compared the construction industry to 'a multi-dimensional marriage' in his keynote address to the DTI's post-consultation conference on improving payment practices in the construction industry.[1] Others were, I am sure, wondering if the conference was going to bear any similarities to the infamous Valentine's Day Massacre of 1929!

On 1st May 1998, Part II of the Housing, Grants, Construction and Regeneration Act 1996 (the Act) came into force. It sought to improve the bitter relationships between the industry's contracting parties. Largely due to a lack of trust prior to the Act, conflicts and disputes were the norm; the Act – heralded as one of the most important pieces of legislation to hit the construction industry for decades – was set to change this.

The legislation introduced adjudication and payment provisions into written construction contracts. The payment provisions dealt with parties' rights to stage payments, procedures for serving notices of sums due and sums to be withheld, a right to suspend work for non-payment and (save in cases of insolvency) a prohibition on pay-when-paid clauses. It was designed to promote best practice and secure fairness and balance between parties to construction contracts. But did the Act achieve its purpose?

A review of the Act was undertaken by Sir Michael Latham who presented his report on 17th September 2004 to the then Construction Minister Nigel Griffiths. The report identified key issues and suggested improvements to both the adjudication and payment provisions. Following this, the DTI drew up consultation proposals on improving the Act to enhance the delivery of minimum standards in the contracting process as the construction industry moved towards integrated construction supply teams and more collaborative approaches to project delivery.

The consultation period ran from 22nd March until 21st June 2005. The 356 responses from the construction industry were considered and on 16th January

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1 The Consultation Document, *Improving Payment Practices in the Construction Industry,* Department of Trade & Industry, March 2005, can be found (together with the related documents referred to below) at www.dti.gov.uk/construction/hgcra/hgcralead.htm.

2006 an Analysis[2], including new Government proposals aimed at improving payment, was published.

The new proposals include:

1. introducing a requirement that certification of the sum due, by one of the contracting parties or a third party, becomes an essential feature of contractual payment mechanisms;
2. removing the section 110(2) requirement for a payer notice;
3. introducing a right to apply for payment where a certificate is not issued by the due date;
4. making certain payment mechanisms, including pay-when-certified clauses, ineffective;
5. enhancing the existing right of suspension under the Act to allow the suspending party to claim for loss and expense;
6. prohibiting the use of trustee stakeholder accounts for awards made by adjudicators;
7. making 'final and conclusive' clauses unenforceable where they apply to decisions under the contract that are of substance to interim payments only; and
8. taking forward the Government's existing commitment to make contractual agreements on adjudication costs unenforceable and to provide a statutory framework for allocating them, including cases where adjudicators resign in response to a challenge to jurisdiction.

The post-consultation conference was part of the next step in the process, which sees the Government working with the construction industry over the coming months to ensure that when amendments to the Act are published for further consultation, they are based upon a clear and thorough understanding of all the issues and reflect the needs of the construction industry and its clients.

One hundred and forty six key figures in the construction industry (representing, amongst others, the Specialist Engineering Contractors' Group, the National Specialist Contractors' Council, the Construction Confederation, the Technology and Construction Solicitors' Association, the Construction Industry Council, the Construction Clients' Group and the Society of Construction Law) got together in one room to listen to some eminent speakers discuss a variety of topics, including the future of business in the construction industry, how the Act has been viewed by the Courts and how the changes to be made to the Act will be implemented by using a relatively new vehicle to reform legislation, the Regulatory Reform Order.

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2 See the publication *Improving Payment Practices in the Construction Industry – Analysis of the consultation on proposals to amend Part II of the Housing Grants Construction and Regeneration Act 1996 and Scheme for Construction Contracts (England and Wales) Regulations 1998*, Department of Trade & Industry, January 2006.

Against this background, attendees participated in debates on specific Government proposals in small groups, each group then reporting back their findings and views on the issues. It is the participation in the debates and the feedback from them which will help reform the Act. The discussion topics, and a summary of the feedback received at the conference, are set out below.

The payment proposals

The question was: should there be a requirement that certification of the sum due, by one of the contracting parties or a third party, becomes an essential feature of contractual payment mechanisms? This was the only issue, in my opinion, where there was considerable polarity in the views expressed by different players in the construction industry.

The current problem is that Section 110(1) of the Act does not go as far as was intended in providing certainty about what sums are due under a construction contract and when. The Act states that every construction contract shall 'provide an adequate mechanism for determining what payments become due under the contract, and when, and provide for a final date for payment in relation to any sum which becomes due'.[3] It is left to the parties to each construction contract to agree an 'adequate mechanism' and incorporate it.

The question of what amounts to an 'adequate mechanism' is a hurdle which parties find hard to address. Not only are construction contracts failing to provide a mechanism which offers certainty of what is due and when, but responses to the consultation process indicate concern about the failure of many contractual mechanisms to bring about effective communication of what is due and when.

The proposal is for Section 110(1) to be amended so that certification of the sum due becomes a contractual requirement. Where a certificate is not issued (resulting in non-compliance with the contract), the payee would have the right to issue an application stating the sum due. The date of the application would then act as the due date, as it does under the Scheme for Construction Contracts. The proposal is intended to create a clear understanding of what is meant by the 'sum due' for the purposes of enforcing the requirement for withholding notices under Section 111 and exercising the right of suspension under Section 112 of the Act.

Many felt that to incorporate such a requirement into a contractual payment mechanism prevented parties to a construction contract from being able to freely negotiate their own terms. Many were also concerned that if, in the absence of a certificate, a payee could apply for the sum due, the payee might inflate the sum due and require payment of an incorrect amount. To counter this argument, though, some said that if an interim payment was incorrect, it could easily be adjusted at the next payment date after the work carried out had been properly valued.

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3 Section 110(1).

Those against a statutory requirement to address this issue (by imposing on parties clear obligations on how to deal in their contracts with certification of the sum due, with the fallback position being that if parties fail to deal with the issue in their contracts in the way which is prescribed by statute then the Scheme for Construction Contracts (in an amended form) will apply), wanted the current position under the Act to remain, with guidance covering best practice, as opposed to legislation, which the industry could follow.

Those in favour of a statutory requirement to oblige certification of sums due argued that this was the only way to provide certainty in respect of such an important issue. Guidance was not something that people would necessarily follow. The general feeling amongst this group was that there was a lack of trust between parties and security of payment was not being offered in contracts.

Sir Michael Latham commented that there had been considerable improvement since the passing of the Act, and the way forward was to find a solution which addressed the fact that it should be a proper amount which is paid on time rather than an amount which someone demands as due or thinks is due.

In addressing the issue of payment, the Government also proposes that the requirement for a Section 110(2) notice under the Act is removed. It is suggested that this notice is unnecessary because if a payer does not believe he should pay what is due under the contract he can utilise the mechanism in Section 111.

This proposal also caused concern. Many construction contracts adopt the position under the Act whereby a payment may be withheld without a Section 111 notice being issued if the Section 110(2) satisfies certain criteria, thus becoming effective as a notice of intention to withhold payment. However, this arrangement depends on a Section 110(2) notice being issued. From a timing point of view, the construction industry seems to prefer the issue of a Section 110(2), which can also act as a withholding notice, rather than doing away with this notice and relying solely on the service of a Section 111 notice to determine what payment is to be made and how much is due.

Why? Because a Section 110(2) notice must be given 'not later than five days after the date on which a payment becomes due ….'[4] This means that the payee receives notice at the beginning of the payment process of what is payable, how the amount is calculated, and (where the notice is capable of acting as a withholding notice) how much is being withheld and on what grounds. If a period between the due date and the final date for payment is stipulated in the contract as being, for example, 30 days, the payee receives his notification within the first 5 days of such period and has time to consider if he agrees what is proposed and raise any issues with the payer.

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4 Section 110(2)

If the Section 110(2) notice is done away with and the issue of a withholding notice is relied on to determine what is paid and when, reliance is being put on a notice which can be issued 'not later than the prescribed period before the final date for payment'.[5] The parties are free to decide what the prescribed period is and in many contracts I have seen, the payer may issue a withholding notice up to two days before the final date for payment. This is terrible news for the payee as he may be working to budgets and cash-flow forecasts which depend on him receiving money at certain times. If a payee only has two days notice of what is being paid, this may not give him enough time to ascertain if he agrees with the payment offered and raise any queries with the payer. It also means that he can only refer the matter to adjudication if the amount is disputed towards the end of the payment process – which will delay the opportunity to receive money even further.

What is clear from the general views expressed at the conference, though, is that there is consensus that the Act does not deal effectively with the question of how and when a debt crystallises and, whatever happens, this issue must be addressed.

'Final and conclusive' clauses

Should 'final and conclusive' clauses be unenforceable where they apply to decisions under the contract that are of substance to interim payments only?

At the conference, a general consensus was reached on this issue. The majority of attendees had no problem with the principle of making 'final and conclusive' interim payment provisions unenforceable, thus allowing adjudicators the right to open up such payment decisions.

However, some did mention that making such payment decisions unenforceable would potentially impact on cases where a variation had been instructed by the employer under the construction contract and a fixed quote for carrying out that variation had been received from the contractor and approved by the employer. In these cases, consideration should be given to the fact that if an employer expects a variation to be carried out for a quoted price, that price should not subsequently be capable of being opened up and adjusted. This is something which will hopefully be borne in mind when the amendments to the Act are drafted.

There was also general agreement that final payments under a contract should continue to be capable of being 'final and conclusive', so that parties could rely on some finality at the end of a project and draw the contract to a close. However, it was felt that to promote fairness, all final payments should clearly be marked as 'FINAL' by the payer (putting the payee on notice that a final payment is being made) and that a final payment should be capable of being challenged within a set time period prescribed in the contract. The JCT contracts currently have a 28 day period within which a final payment can be

5 Section 111(2)

challenged and attendees generally felt that it was sensible that a provision along these lines was retained in all construction contracts.

Trustee stakeholder accounts

The question was: should the use of trustee stakeholder accounts for awards made by adjudicators be prohibited? If so, this might lead to more claims in court that the receiving party is insolvent, and the conference attendees were asked whether they thought that the TCC's guidance is sufficiently clear on when it is likely to stay an adjudicator's decision.

The general position at the conference was 'yes', the use of such accounts should be prohibited. The ability of contracting parties to agree terms which negate the effect of adjudication was a regulatory loophole that needed closing.

The problem at the moment is that parties may contract on terms which allow adjudicators' awards to be paid into trustee stakeholder accounts pending final determination of the dispute in the courts or by way of arbitration. This prevents adjudication from being used in the way it was intended under the Act. It may also have cash-flow consequences for the party in the dispute which has suffered at the hands of the other.

There were limited circumstances where it was felt by some that the use of such accounts should be accepted. These included circumstances where there was a risk that the recipient of the award would become insolvent before the dispute was finally determined and where an award of public money was made.

However, it was agreed that the TCC's guidance on when it is likely to stay an adjudicator's decision is sufficiently clear[6] and, therefore, why should it not be left to the courts alone to decide when a stay in enforcing an adjudicator's decision should be granted?

Interestingly, not many attendees had direct experience of the use of trustee stakeholder accounts. One person who had had experience said that whilst the contractual provision authorising the use of a trustee stakeholder account in a dispute allowed the receipt of money into the account, there was no corresponding provision explaining how the money would eventually be released from the account!

'Evidenced in writing'

The question was: is it correct that any amendment to Section 107 of the Act on contracts evidenced in writing would need to take account of the courts' emphasis on certainty of all the contract terms for adjudication to be workable?

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6 See *Wimbledon Construction Company Ltd v Derek Vago* [2005] EWHC 1086 (TCC).

This question did not form part of the formal consultation process but the Government is interested in the views of the construction industry and is considering amending the Act to deal with the Court of Appeal's decision in *RJT Consulting Engineers Ltd v DM Engineering (Northern Ireland) Ltd*.[7] The Court of Appeal held that on the proper construction of Section 107, it was the terms, and not merely the existence of a construction contract, which had to be evidenced in writing in order for the contract to fall within the scope of the Act. The whole of the agreement had to be evidenced in writing, not part of it, as writing provided certainty which was important when adjudication, which would have to take place under a demanding timetable and agreed procedure, was envisaged.

Respondents during the consultation process took issue with this decision on three grounds – with which attendees at the conference generally agreed.[8]

1. When construction contracts are agreed, this is usually based on an incomplete agreement of the contract terms, with an understanding that a full agreement will be finalised in time. This is a consequence of the industry's advertising and tendering process where tenders are submitted on the understanding that a particular standard form of contract will be used. It is only after tenders are submitted that bespoke contract amendments are put forward for negotiation. It is the final process of agreeing the bespoke amendments which is often not completed, opening up grounds for a dispute as to whether the Act applies if the contract was never properly finalised and fully recorded in writing.

2. The drafting of Section 107 is based on Section 105 of the Arbitration Act 1996 which requires that an arbitration agreement between parties to an arbitration should be evidenced in writing. In that context, it is argued that the provision makes sense as there is no statutory fallback where all the terms of an arbitration agreement are not properly and fully recorded. It is suggested that this provision does not make sense when interpreted in the context of adjudication, and that the requirement that all contractual terms should be agreed in writing is excessively narrow.

   With adjudication, if, for example, the adjudication procedure is not fully set out in the contract in accordance with the procedure set out in Section 108, there is a statutory fallback procedure set out in the Scheme for Construction Contracts which can be relied upon. Therefore, if the adjudication procedure is not agreed in writing, or with any certainty, the legislative framework can still be effective. By similar argument, wherever the Scheme for Construction Contracts provides a statutory fallback position in respect of parts of the contract which do not comply with the Act,

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7 RJT Consulting Engineers Ltd v DM *Engineering (Northern Ireland) Ltd* [2002] EWCA Civ 270.

8 See the *Analysis* referred to in note 2.

any parts of the contract which are not fully agreed in writing but are covered by the Scheme should not prohibit the contract from falling within the ambit of the Act.

3. An adjudicator's decision about what terms of a contract are agreed can be equally complex whether or not the whole contract is recorded in writing at the time the dispute is referred to adjudication. Parties can still, at this time, dispute what is finally agreed and whether all bespoke amendments are applicable. Where an adjudicator is deciding a dispute on a contract which is in the course of being negotiated and agreed during the progress of the works, the making of his decision will also be based on an extremely complex set of facts. In every case, the adjudicator's decision should be based on the evidence before him and the balance of probabilities. The Court of Appeal's narrow interpretation of Section 107 means an adjudicator can only make a decision on an agreement which is fully recorded in writing.

The thrust of the argument is that unless the requirements relating to contracts being evidenced in writing are changed, many contracts may not be caught by the Act which undermines the Act's intentions. Without clarity of this issue, it may be easy for a party to argue that there are terms which are not recorded and, therefore, the whole contract is not in writing so the Act does not apply. Those at the conference agreed that Section 107 should be amended so that the UK has less stringent requirements for contracts to be evidenced in writing. Where there is a mixture of written and oral terms, or even wholly oral terms, these contracts should not be excluded from the ambit of the Act. All contracts, no matter what their form, should be capable of being adjudicated.

It was suggested that the Government should look at similar legislation in other jurisdictions (which seem to work satisfactorily elsewhere), such as that in New Zealand. Section 9 of the Construction Contracts Act 2002 generally applies to 'every construction contract that relates to carrying out construction work in New Zealand … and is written or oral, or partly written and partly oral'.

Suspension

In relation to the suspension proposals, the following questions were asked. Should the remobilisation period be limited to a maximum period notified in the notice of suspension? Should the suspending party seek the payer's agreement to provide certain services under the contract during the suspension period to ensure statutory obligations are met and to reduce the costs of remobilisation? Should the Act enhance the existing right of suspension to allow the suspending party to claim for loss and expense?

Agreement on these issues was generally reached amongst attendees. The conference decided that a suspending party should be entitled to recover loss and expense in respect of any suspension and subsequent re-mobilisation. This view also applied to any loss and expense suffered as a result of a

suspended party having to return to site during a suspension in order to carry out services to ensure that statutory obligations continued to be satisfied.

Regarding the period of re-mobilisation, it was generally felt that stipulating a maximum period for re-mobilisation in a suspension notice was a non-starter. Suspension is a right given to the innocent suspending party in circumstances where the payer has not paid the sum due in full, and no effective notice to withhold payment has been given. The payer's breach could go on for a short period or, in theory, indefinitely. It would really depend on how long the breach subsisted before the suspending party would be able to indicate how long it would take him to get back on site, following receipt of the sums due.

Where the breach is likely to go on for some time, the suspending party will probably go off-site and secure work on another project, using and committing his resources elsewhere, and making it harder for him to return to the site quickly. It was felt that there is no good reason for forcing the innocent party into a position where at the outset of the suspension, he must commit to coming back on site within a maximum period. The only duty of the innocent party in this respect should be to return to site as soon as reasonably possible, ensuring that a return to site was, for the purposes of recovering loss and expense, subject to all the usual rules of mitigation of costs.

Regarding the provision of certain services during a suspension period, it was generally felt that this should not be done in order to reduce the costs of re-mobilisation. Re-mobilisation costs are only going to be necessary because the payer has committed a breach in the first place and, again, it was felt that there is no good reason for obliging the innocent party to do anything on site in the absence of being paid what is due to him.

However, when it came to providing services on site to ensure compliance with statutory obligations (such as health and safety where the duties of, for example, principal contractors and planning supervisors are on-going) the conference decided that in these circumstances, permission from the payer to go on site should not be sought or required at all. The suspending party should simply have an immediate and unquestionable right to go on site at all times when required to do so in order to comply with his statutory obligations. The only thing the suspending party ought to do in these circumstances is notify the payer that he is going on site to carry out services in pursuance of such obligations.

The additional costs incurred by the suspending party in carrying out his statutory obligations (the cost of providing these services is likely to be more than originally priced for because labour and materials are not permanently on-site) should be recoverable by the suspending party through a loss and expense claim.

Shortly after the issues had been debated, the conference concluded and, I might add, without any blood being spilt! In fact, people addressed the floor and said that given the bad times and the bad relationships within the industry which existed prior to the Act coming into force, it was amazing to see so many different players in the industry get together in one room, quite

amicably, to discuss the future of the UK construction industry. Certainly my impression from this exciting event, which was probably the best conference I have been to in my career to date, was that the industry is keen to resolve its differences and that, in respect of the issues raised at the conference, the players are not necessarily too far apart in their views to make this an impossibility.

It now comes down to submitting amendments to the legislation which are realistic enough to be passed. If we are to go forward with a Regulatory Reform Order (and it is hoped that legal clearance on the text of a Regulatory Reform Order could be obtained as early as this Spring) to amend the legislation we need to show qualitative and even anecdotal evidence in support of the changes. Ultimately, it will be Parliament which finally determines the desirability of a Regulatory Reform Order on the basis of the evidence and the arguments put to it. Let's make sure we achieve changes which will make our construction industry an industry to be proud of.

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