

Buildlaw Newsletter

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Construction Act changes to payment rules get the green light

Back in 2004, Sir Michael Latham was asked to review the operation of Part II of the Housing Grants, Construction and Regeneration Act 1996, known to most in the industry as the Construction Act. After two public consultations and a year going through Parliament, the Government's proposals for change (with a few alterations) have become law. The date on which they will take effect is yet to be announced but these are the key changes.

Commentators in the construction press have been full of bright ideas about how the Construction Act should be changed to make things fairer, more efficient and less likely to be the subject of dispute. Many competing ideas have been put forward by industry lobby groups during the consultations in 2005 and 2007 and again during the Parliamentary progress of the Government's final proposals. Finally, those changes have become Part 8 of the Local Democracy, Economic Development and Construction Act 2009, which received Royal Assent in November 2009. Part 8 operates so as to amend the 1996 Act.

The Construction Act is at the core of essential contractual relationships in the construction industry. Its provisions at present apply to construction contracts as defined by the Act, based on a broad range of listed construction operations, where a contract is made or evidenced in writing. The 1996 Act banned "pay-when-paid" clauses, required contracts to provide for periodic or stage payments and gave force to the withholding notice. It made compulsory in contracts the ability to

choose to resolve disputes by adjudication. Most importantly, parties cannot contract out of its overriding requirements. These rules still exist but the changes seek to protect further those down the contractual chain from payment being delayed or refused.

Payment provisions

The current requirement to give a s110 payment notice is frequently ignored but parties to a construction contract are usually alive to the significance of serving a s111 withholding notice in time if the paying party believes it has grounds to deduct sums from payments that are due. This principle of "pay now, argue later" so as to maintain cashflow has arguably not been fulfilled to the extent envisaged by the 1996 Act so the 2009 Act makes the consequences of not serving a payment notice far more significant.

Payment notices from payers and payees

A contract still has to provide that a payment notice stating the sum due and the basis for calculation is served by the paying party not later than 5 days after the payment due date, even if the sum is zero. Now, the payer's payment notice can be given by a specified person, apparently with the intention that a payment certificate issued by a contract administrator under some forms of contract will meet the requirement.

The real change in emphasis, however, is that if the payer does not serve its notice, the payee can serve its own payment notice. Even better for the party being paid, if the contract requires an application for payment,

the payee's application can stand as the payee's notice (if the payer fails to notify). So if a sub-contractor makes a monthly application but the main contractor does not pay attention to the dates and serves no payment notice, he would be obliged to pay the full amount of the application, even if on a closer analysis there would have been good grounds for refuting parts of the claim. This seeks to sanction the lazy or obtuse employer or main contractor.

Withholding notices will still exist under a slightly different guise: once the "notified sum" is established from the payment notice, the paying party can serve a "pay less" notice if it has proper grounds for not paying the full amount.

Insolvency

There is one exception. If the contract states that if the payee becomes insolvent the payer need not pay any sum due and the insolvency occurs after the deadline for the "pay less" notice, the payer need not pay. This reflects the position in the 2007 House of Lords decision in *Melville Dundas v George Wimpey* but clarifies perhaps that eroding the principle of no deduction without a timely withholding notice is limited to insolvency situations.

Conditional payments

Contractual payment rules will no longer be the "adequate mechanism" required by the 1996 Act if they make payment conditional on:

- a) the performance of obligations under another contract; or
- b) a decision by any person as to whether obligations under another contract have been performed.

This makes it clear now that "pay-when-certified" clauses are prohibited. The main contractor won't be able to tell his subbie that he's waiting for a certificate from the employer.

Similarly, it will not be possible for contracts to provide that it is the payment notice that determines when a payment becomes due. The intention seems to be that due dates should be determined by the contract, to achieve some certainty.

The objective is once again to offer protection to the party down the contractual chain being paid for work. He is often far-removed from obligations under other contracts and those making decisions about them.

This change has the potential to have the biggest effect

on the risk profile of PFI/PPP projects. The Construction Contracts (England and Wales) Exclusion Order 1998 exempted from the 1996 Act PFI/PPP Project Agreements, (i.e. the contract entered into between the public sector body and the private sector party providing the long term service (the "SPV" - Special Purpose Vehicle). However, the exemption did not apply to the sub-contracts entered into by the SPV with its various sub-contractors (which in PFI/PPP projects includes the main building contractor) who are carrying out "construction operations" meaning that such sub-contracts are still subject to the 1996 Act. The SPV in a typical PFI/PPP project utilising limited recourse project financing is effectively a shell company that is thinly capitalised and is set up exclusively to deliver the project. In order to manage cash flow risk it needs to be able to ensure that it will not incur a liability to a sub-contractor before it receives a corresponding entitlement from the public sector counterparty to the Project Agreement. With "pay-when-paid" clauses banned by the 1996 Act, "pay-when-certified" clauses have been essential to the process known as equivalent project relief (EPR), which provides for equivalence in relief and payment entitlement down the contractual chain. The use of EPR provisions had already been questioned as being contrary to the 1996 Act by the decision in *Midland Expressway v Carillion Construction (No.2) (2006)*.

Despite some heavy lobbying for the 2009 Act to exclude PFI sub-contracts from these provisions, the requirements remain. However, some hope remains for that lobby by virtue of a late amendment in the final stages of the House of Commons that gives power to the Secretary of State, Welsh Ministers and Scottish Ministers to disapply any or all of the provisions of Part II of the 1996 Act to construction contracts specified in that order. This gives flexibility because the 1996 Act was all or nothing - either the provisions applied or they did not. It might be that an order is issued to disapply this specific provision in PFI sub-contracts but at present the intentions remain unclear.

More will be known once it is established when the 2009 Act will come into force and what further regulations the Government issues that might affect the issue. In the meantime, in order offer protection to Project Companies and ultimately, preserve bankability of PFI/PPP transactions, reliance is likely to be placed on the following mechanisms: (i) parallel loan agreements, the terms of which ordinarily require the sub-contractor or its parent company to "loan" amounts back to the SPV to fund any payment mismatch until

the matter is finally resolved under Project Agreement; (ii) providing for deferred payment of sums which become due until expiry of a longstop date of, for example, 2 years or receipt by the SPV of a corresponding payment under its Project Agreement, whichever is earlier; or (iii) "claw back" provisions in sub-contracts to enable the SPV to recover from its sub-contractor any amounts it receives under its sub-contract to the extent such amounts exceed the amount received by the SPV under the Project Agreement.

Suspension for non-payment

A contractor's ability to suspend for non-payment has existed since the 1996 Act, but Section 112 has been amended to confirm that the contractor can suspend "any or all of" his obligations, so it is no longer an all-or-nothing weapon. The Contractor will also be entitled to recover reasonable costs reasonably incurred if the right is exercised.

Oral contracts

The 2009 Act widens the remit of the legislation by repealing the requirement that a construction contract be made or evidenced in writing before the legislation applies. Current case law interprets this requirement to mean that all non-trivial terms have to be in writing but contracts (or parts of them) agreed verbally will now be covered by the legislation. For an agreed adjudication procedure to apply it must be in writing and cover the 8 points required by the Construction Act failing which the adjudication procedure in the Scheme will apply, so for oral contracts the Scheme adjudication procedure is likely to be used. The motivation seems to have been to bring disputes about oral contracts into adjudication, rather than tying up the courts.

Even with documents to set out the key terms, adjudicators sometimes have quite a task to reach an accurate decision in 28 days. For oral contract disputes, witness statements setting out each party's version of the conversations are likely to be more prevalent. Adjudicators cannot take evidence on oath but will surely need more meetings with the parties to explore the terms agreed and perhaps whether a contract actually exists. Some question how this will meet the stated objective of reducing adjudication costs.

Adjudication: costs and errors

The success of adjudication for deciding disputes is in part attributable to its accessibility and the fact that,

generally, the parties bear their own legal costs and the adjudicator decides who pays his fees. However, the 1996 Act did not restrict what the parties could agree, which has "led to a practice in the industry whereby the party with the most bargaining power can insert a clause into the construction contract requiring that if the weaker party wants to go to adjudication ... they would have to pay all the superior party's legal and other costs, and all the fees and expenses of the adjudicator", according to Lord McKenzie of Luton, who steered the legislation through its final stages for the Government. The concern has been that such bespoke restrictions stifle the right to adjudicate. Clauses that relate to the allocation of adjudication costs between the parties will now be ineffective unless made in writing after the adjudication has begun (although this seems unlikely in practice) or, following an amendment late in the passage of the Bill, unless it is a written term of the construction contract that gives the adjudicator the power to allocate his fees and expenses.

Through decided case law, adjudicators have had the ability to correct a slip in their decisions (such as an error in arithmetic) but this has now been given statutory force.

What next

As the date for the 2009 Act coming into effect is awaited, the next development should be consultation on a revised Scheme for Construction Contracts. That is the piece of legislation that fills in some of the detail if a construction contract fails to comply with the 1996 Act. The indication given to Parliament was that a draft could be expected in early 2010.

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Briefing Note: Fitzroy Robinson v Mentmore Towers and others

Readers may be interested in this recent High Court case, in which it was held that a firm of architects were held to have committed fraudulent misrepresentation by not revealing the true composition of its project team.

Fitzroy Robinson was engaged by the three defendant companies as the architect to develop buildings in London's Piccadilly into an exclusive private members' club, and Mentmore Towers in Buckinghamshire into a country house hotel.

Mr Blake was the director of Fitzroy Robinson and was responsible for putting together the bid documents. Mr Blake was also involved in all the pre-contract meetings. The defendant companies were told by the CEO of Fitzroy Robinson that Mr Blake would be the team leader of the project throughout.

Work started on both projects in March 2006 and completion was scheduled for May 2009. On 17 March, Mr Blake resigned from Fitzroy Robinson and began working his one year notice period. Fitzroy Robinson did not inform the defendant companies of Mr Blake's resignation until November 2006.

Planning permission was delayed from December 2006 until November 2007, with the defendant companies contending that this was the fault of Fitzroy Robinson.

In June 2007 the defendant companies had stopped paying Fitzroy Robinson the fees payable under the three contracts, so in April and May 2008, Fitzroy Robinson issued proceedings for over £1million in unpaid fees. The defendant companies responded that Fitzroy Robinson's claims had to be adjusted to reflect the delayed progress of the projects. The defendant companies argued that they had suffered loss as a result of the delay that Mr Blake's resignation had caused.

The defendant companies also counterclaimed that they had been fraudulently misled into engaging Fitzroy Robinson. This was based on Fitzroy Robinson's conduct in concealing the resignation of Mr Blake before the contracts were signed.

Mr Justice Coulson refused to accept the evidence of Fitzroy Robinson's CEO and held that Fitzroy Robinson's failure to correct the representation of Mr

Blake's continuous involvement throughout the project was an actionable misrepresentation. The fact that it had been made knowingly and deliberately, without an honest belief in its truth meant that it was therefore fraudulent. However, even though it could be said that the defendant companies would not have entered in to the contracts if not for this fraudulent misrepresentation, they had failed to show that Mr Blake's resignation caused any delay to the project. Therefore that part of the defendant companies' counterclaim was likely to be quite modest.

This case serves as a warning to those bidding for work with their most impressive team and not subsequently using that team for the work won. In light of this decision it is advisable that any changes to personnel named in the contract or at the pre-contract stage are notified in writing to the Employer to avoid potential liability for misrepresentation, fraud or breach of contract.

However, as in this case, it may prove difficult in practice to show and quantify losses arising from the departure of an individual from a professional project team.

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False self-employment - HMRC takes a closer look

The Treasury and Her Majesty's Revenue and Customs ('HMRC') have jointly published a consultation on dealing with what could be seen as false self-employment in the construction business.

Why is this important for the construction industry?

At present a large number of individuals work in the construction industry as self employed workers. This has an effect on the tax and National Insurance Contributions ('NIC') HMRC can collect from these workers.

As HMRC collects significantly more money in taxes from people classed as 'employees' than those classed as 'self employed' they are keen to establish that those who see themselves as self-employed, truly are self-employed. This has led to an increasing number of cases where HMRC has challenged the self-employed status of workers. However HMRC's 99% failure rate in these cases appears to have caused them frustration resulting in the proposed new false self-employment rules.

The proposed new rules will impose an increased burden on the construction industry as firms will have to bear the costs of increased NICs and deal with additional administrative returns.

What is 'false self-employment'?

False self-employment can occur when the way in which work is carried out by a self employed worker may, in fact, be seen as an employment relationship. At the moment it is difficult for HMRC to challenge the worker's status and change the levels of tax and NIC payable.

Government statistics suggest that between 200,000 - 400,000 workers in the construction industry are being falsely self-employed, with a loss of around £350 million a year in taxes and NICs.

What are the new rules?

At present the Courts and Tribunals rely on principles long established by case law to help decide if someone is an employee. These are:

- mutuality of obligation and personal service;
- a right of control; and

- terms in the contract which are consistent with it being a contract of service.

Another test considers whether the worker is 'in business on his [or her] own account'.

The consultation proposes that a worker will be regarded as self-employed if they meet one of the criteria below:

He or she:

- provides the plant and equipment needed for the job (excluding tools and equipment workers would normally be expected to provide for themselves);
- sources and provides all the materials used; and
- provides other workers, if the worker in question is personally responsible for paying them.

One concession is that the rules will only affect the status of the individual for tax purposes, and will not affect their general employment rights.

Impact

The Government has said that is mindful of the heavy impact that the recession has had on the construction industry, and is keen to avoid imposing a large and unexpected tax demand at a time when firms can least afford it. It has stated that the new rules would only be brought in at a time when the sector can weather them, but has not confirmed exactly when this would be.

It has been argued that the proposals may provide a greater degree of certainty about tax status which will assist the industry in its financial planning, and will reduce the risks and costs of challenges to workers' status brought by the HMRC.

We will have to wait to see the full extent of the impact of the false self employment rules on the construction industry as it tries to recover from the effects of the economic downturn.

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Nature of Pre-Contract correspondence

This issue was examined in *Chartbrook Ltd v Persimmon Homes Ltd*, one of the final cases before the House of Lords prior to its replacement with the Supreme Court.

This case concerned the extent to which pre-contract correspondence could be used to assist interpretation of a complex payment formula which, interpreted using ordinary rules of syntax, made no commercial sense.

It was held, in accordance with established principles of law, that all that was required for a Court to correct a mistake in a contract was that it should be clear that something had gone awry with the language and it should be clear what a reasonable person would have understood the parties to have meant.

The House of Lords was of the opinion that taking pre-contract correspondence into account when interpreting a contract led to an uncertain, subjective approach and

was not reconcilable with the objective 'reasonable person' approach above. The pre-contract correspondence was therefore not admissible as assistance with interpretation of the contract.

This case emphasises the importance of proper drafting of a contract.

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What is the main focus of your work?

"The main focus of my work is contentious and non contentious legal advice on construction issues, for example dispute resolution where I have a particular interest in adjudication. I am a practising adjudicator on industry panels as well as regularly representing clients in adjudications and court enforcement proceedings. My non contentious work includes advising on and drafting construction contracts such as JCT, NEC3, PPC2000, I/Chem/E and associated documents such as collateral warranties, parent company guarantees, performance bonds and novations as well as consultant appointments.

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What do you particularly enjoy about your work?

What I particularly enjoy about my work is getting results for clients, for example recovering more than £1million in damages for an NHS Trust in a technically complex case was very satisfying but also recovering large sums of money on behalf of contractors. I enjoy the law and advising clients on how to get the most out of a particular situation.

What have been your highlights of 2009?

My highlights of 2009 have included advising a Czech contractor on issues arising out of the construction of a power station in Bulgaria, Bulgaria's largest inward investment project to date and advising the M & E contractor on the contract for the 2012 London Olympics Athletes Village as well as the team advising a Contractor on the contract for the London Olympics Media Centre. I also enjoy the feel good factor that comes from being part of an increasingly successful and vibrant construction law department!"