

Review of Part II of the Housing Grants Construction and Regeneration Act 1996

Chairman's Final Report of the deliberations of the Payment Working Group

1. Introduction

1.1 The Construction Act Review payment working group has met seven times during the preparation of this final report of its recommendations for improvements to the payment provisions of Part II of the Housing Grants Construction and Regeneration Act 1996. Improving payment practices in the construction industry is at the heart of the legislation and, similarly, was at the heart of the Government's plans for a review. In his budget statement of March 2004, the Chancellor of the Exchequer stated that:

“Following concerns expressed by the construction industry on unreasonable delays in payment, the Government will review the operation of the adjudication and payment provisions in the Housing Grants, Construction and Regeneration Act 1996 to identify what improvement can be made.”

1.2 In the light of that announcement and with considerable support from Sir Michael Latham and the Government, the group has attempted to explore fully the issues raised by:

- the paper produced by the Cabinet Office on the conclusions of its feasibility study for the review;
- the responses to Sir Michael Latham's March letter to the Construction Umbrella Bodies, in which he sought recommendations for improvements to the operation of the Construction Act.

1.3 The group has considered ten issues proposed through the above exercises by various groups in the construction industry. It has then considered how to address them so that the operation of the Act's payment provisions can be improved. In relation to each of the issues that was raised, the working group attempted to answer two questions:

- Was there a genuine issue which the working group understood ought to be addressed given the evidence and opinion around the table?
- Was the working group able to make a clear recommendation for improvement to the operation of legislation in relation to an issue it had identified? Such a recommendation should set out the principles that any improvement would seek to introduce to the operation of the legislation rather than to prescribe any detailed legislative amendments.

1.4 Given the need for a consensus agreement on any recommendations, in general during the discussion, the chairman has not put questions to the vote or sought unanimous agreement. It seems clear that if a significant proportion of the construction supply chain has encountered an issue then this issue should rightly be considered and a solution sought by the whole supply chain where possible.

1.5 At the conclusion of its discussions, the group is able to make five specific recommendations. These are:

- to improve the right to suspend performance under the contract in cases of non-payment;
- to limit the right to agree contractual provisions on cross contract set-off;
- A right should be provided for a third party payer to pay all or some of the unpaid funds to the payee in cases where the original payer is insolvent
- to remove section 110(2) of the legislation, which requires the contract to provide a formal payment notice and a “due date” for payment;
- to clarify the definition in the legislation of the “adequate mechanism” required of the contract by section 110(1), to ensure a payment crystallises between the parties before the payment date;

1.6 The final two recommendations are intended to address the problems of:

- failure to submit a section 110 notice and failure of the legislation to provide any sanction for such failure; and,
- the confusion over what entitlement arises at the current “due date” in the legislation as this falls at a time when no payment is made.
- lack of certainty over the payment to be made.

1.7 The principles which the group has concluded should guide the making of these amendments are set out on the following pages. Section 2 of the report also sets out the conclusions of the group’s discussions on the following other issues where no recommendation is made:

- the failure of payers issuing withholding notices under section 111 of the Act to provide adequate detail of the reasons for withholding.
- the current exception provided by the legislation to allow the use of pay-when-paid clauses in cases of insolvency.
- The use of conditional payment provisions where the payer stipulates in a subcontract that payments will only become due to a subsequent payee when payments to him are certified under the main contract. The timing and content of the certificate can be unknown to the payee and may not include specific reference to the subcontract payments.
- the practice of only making stage payments available under the contract when work begins on site (there is only a limited consensus that the Act discourages payments for work off-site though I personally would hope there is scope to improve it if only through guidance).
- what appears to be the increasing length of payment periods experienced by contractors (though many measures identified in this review are likely to address payment abuses, this group can identify no effective measure to prevent any lengthening in contractual payment periods).
- the suggestion by specialist subcontractors that the Act should be used to introduce a statutory right to seek security of payment in construction contracts.

1.8 The members of the Construction Act Review Payment Working Group are:

Richard Haryott – Chairman

Paul Smith – Secretary

John Bradley – Construction Confederation

Rosemary Beales – Construction Confederation

Catriona Dodsworth – Technology and Construction Court Solicitors' Association

Marc Hanson – Construction Clients' Group

Rudi Klein – Specialist Engineering Contractors' Group

Neil McKay – Scottish Construction Industry Group

Christopher Parker – Construction Confederation

Justin Perry - National Specialist Contractors' Council

Rod Pettigrew – Specialist Engineering Contractors' Group

Suzanne Reeves - Technology and Construction Court Solicitors' Association

Marion Rich – Specialist Engineering Contractors' Group

Philip Shearer – Construction Industry Council

Henry Sherman – Construction Clients' Group

Jo Simcock – National Specialist Contractors' Council

John Tebbitt – Construction Products Association

Nick Walden – Construction Confederation

Graham Watts – Construction Industry Council

Graham Wren – National Specialist Contractors' Group

Eric Arnold – Cabinet Office

Tony Mulcahy – DTI

2. Detailed recommendations

2.1 Failure to submit a section 110 notice and failure of the legislation to provide any sanction for such failure

The issue

2.1.1 The review has concluded that the requirement to serve a payment notice under section 110(2) of the legislation is frequently ignored and is not backed by any sanction that might apply when the notice isn't served. It was also noted that serving such a notice is not part of a natural payment process in the industry. The review has concluded this is a failing in the current legislation, because an adjudication, the usual sanction in cases of non-compliance with terms in the contract, would only be likely to conclude that the notice should have been served, but little more.

Potential solutions

2.1.2 The group considered:

- retaining the requirement for a section 110(2) notice and backing it with the introduction of some form of sanction.
- the removal of section 110(2) of the legislation.

2.1.3 This second suggestion has the added benefit of removing the concept of a “due date” for payment, which appears in the legislation in addition to the “final date”. This seems to create confusion about when the Act enables a payee to make a claim to recover a debt. If a payee makes such a claim because they have not yet received a section 110(2) notice, the claim cannot be upheld, as no sum is due for payment before the final date and will be subject to withholding before it becomes due for payment. It is therefore proposed that the due date and the final date should be combined at the final date, the point when it actually becomes possible to bring a claim. Meanwhile the payment process would begin at an “ascertainment date”.

2.1.4 The group has therefore concluded it would be better to remove section 110(2) and instead set out more clearly what constitutes an “adequate mechanism for determining what will be paid and when” in the contract, as required by Section 110(1) of the Act. TeCSA, as an independent body of legal experts, was asked to advise the working group on what would constitute such a mechanism. They suggested such a mechanism should include agreement of:

- What amounts are determined
- When does this determination occur
- How these amounts are to be calculated/assessed
- When the payment determined must be made (i.e. debt crystallisation). This date would be referred to as the Payment Date.

- The provision of information (who provides what, to whom and in what level of detail)
- What happens in default of operation of the contractual mechanism
- How are entitlements (e.g. loss and expense and retention) to be determined and paid?.

2.1.5 The group spent some time considering whether a payee application should be introduced to the legislation. TeCSA's suggestion to the group was that this represented the best means of introducing a simple default mechanism into contracts for failure to operate the mechanism. The amount claimed as due by the payee would become payable if no withholding notice were served. This has the advantage of "commercial logic" and provides clarity about the status of an application in the legislation, a matter which, somewhat inconsistently up to now, has been left only to contract. Under some contracts at present, no application process is necessary but TeCSA do not believe the introduction of such a process is onerous given the flexibility the parties and contract writing bodies have to introduce an application process to standard contractual terms.

2.1.6 TeCSA's final proposal to the group included two safeguards to prevent the problem of a payment being forced to be made which is not properly due under the contract:

- a notice by the payee as a reminder to the payer to observe the process in the legislation before the date for payment;
- a provision allowing any sum paid which was not due under the contract to be revised subsequently by an adjudicator, judge or arbitrator or taken into account in a subsequent payment.

2.1.7 The group also discussed the additional safeguard of making it a requirement that applications for payment should be for sums properly due under the contract. This would allow an adjudicator to reopen the claim and ensure that any payment referred to adjudication would be assessed and not become simply the amount claimed.

Recommendations

2.1.8 There is merit in the removal of section 110(2) of the legislation, which requires the contract to provide a formal payment notice and a "due date" for payment. Instead of the due date, the legislation should provide for an "ascertainment date" on which the payment process is should start.

2.1.9 The legislation should instead set out more clearly what constitutes an "adequate mechanism for determining what will be paid and when" in the contract, as required by Section 110(1) of the Act to ensure the payment crystallises

2.1.10 The group has also considered the following additional recommendations from TeCSA, though there was no agreement on them:

- That a default mechanism should be included in the legislation to allow the payment to crystallise between the parties when the adequate mechanism fails or is not implemented during the payment process.
- TeCSA recommended this should be based on the provision of a process of application for payment, subject to withholding, and could be backed by safeguards of:
 - a notice by the payee as a reminder to the payer to observe the process in the legislation before the date for payment;
 - allowing an adjudicator to open up whether the amount claimed was properly due under the contract;
 - allowing any sum paid which was not due under the contract to be taken into account on a subsequent payment;
 - allowing any sum paid which was not due under the contract to be revised subsequently by an adjudicator, judge or arbitrator.

2.2 The use of conditional payment provisions that make the timing or entitlement to payment dependant dependent upon the issue of a certificate with the intention of allowing payment to be decided when it has been received from higher up the contract chain

The Issue

2.2.1 The practice of including “pay-when-certified” clauses in contracts is regularly used and, it is claimed, can have the same effect as a “pay-when-paid” clause. “Pay-when-paid” clauses were made ineffective under the original Act (Section 113) and the review group is agreed that it would be inappropriate to allow a loophole to allow the practice to continue through a different mechanism.

2.2.2 In many contracts, certification by a supervising officer of payments under the main contract is a normal and effective method of confirming sums due. Pay-when-certified clauses take a variety of forms and either link the timing of the payment process under the subcontract to that of the certificate under the main contract or link the amount to be paid under the subcontract to the amount certified under the main contract. The group agreed that at its worst the problem created by the use of these clauses is the effect of:

- the certificate being received by the payer from a supervising officer without the knowledge of a subsequent payee;
- the payer not issuing any form of notice to the payee of the payment to be made to him, possibly on the basis that an individual item of work has not been certified*;
- the payee being left unaware that the payment process is now underway;
- the payment, or a withholding notice under section 111, or both, being issued very late in the payment cycle after the payer has been paid;
- the payer only explaining the payment or grounds for withholding in response to a referral to adjudication;
- little or no opportunity for the payee to respond;
- the agreed mechanism for payment required by the Act becomes ineffective as a result.

*More usually the payment notice is not served through the abuse of section 110(2) of the legislation. The fact a certificate is received would usually trigger the notice.

Potential solutions

2.2.3 The group considered a number of proposed solutions to the problem. These included:

- an absolute ban on all conditional payment provisions through section 113 of the Act;
- ensuring that the dates provided by the “adequate mechanism to determine what is to be paid and when” in section 110(1), should be a series of calendar date rather than event, as the lack of transparency over the event in part leads to the pay-when-certified problem;

- going to adjudication on the basis that the lack of transparency over the event renders the mechanism in the contract inadequate;

2.2.4 The group agreed that a certification process itself is frequently a natural and normal part of the contracting process. A paper put to the group by the Construction Industry Council considered the extent to which the parties were able to agree terms which would enable the payment process to move forward on the basis that a certificate should be timed to allow proper consideration by the contractor before payment to the subcontractor was finalised. It is clear that this process does not require the use of conditional pay-when-certified clauses and is relatively simple.

2.2.5 However, the group has agreed that, other than in cases of management contracting or employment of nominated subcontractors, a certificate does not directly approve payments to the subcontractors. The client's certifying officer can only approve payments under the main contract and may well not disaggregate the individual subcontract elements in the certificate or price them in the same way under the main contracts as they are priced under the subcontract. As such, the effect of a pay when certified clause can allow a payer to defer payment to a subsequent payee on the basis that there is no clarity as to whether or not a sum has been certified.

2.2.6 Some on the group argue that the intention of contractors in seeking subcontractors' agreement of these clauses is quite different from that of pay-when-paid clauses. They have suggested it may be quite reasonable for the parties to agree to share the risk of a late certificate, when it is in both parties interest that it should be served. They also point out that once the payment to the main contractor becomes due, if it is delayed, the main contractor has no right to withhold any payment due to the subcontractor, as he would under a pay-when-paid clause.

2.2.7 The group agrees that the improved definition of an "adequate mechanism" will improve the situation by addressing the problem of poor transparency in the process. However, the worst effects of pay-when-certified clauses seem to result from the failure of some payers to abide by the terms of the contract. This could continue under the improved definition of an adequate mechanism.

Recommendation

2.2.8 The group was unable to reach a consensus conclusion.

2.3 Failure of payers issuing withholding notices under section 111 of the Act to provide adequate detail of the reasons for withholding

The issue

2.3.1 The problem here is the failure of the payer to provide enough detail when issuing a withholding notice for a payment when it is due.

Potential solutions

2.3.2 Two examples of possible wording were discussed. These proposed that the notice should be:

- in comparable detail to the application for payment;
- quantified and in reasonable detail;

2.3.3 Both wordings were rejected by certain members of the group on the basis that the requirement could lead to further disputes about whether an appropriate level of detail was provided. Other members of the group thought they were necessary in the same way that section 110(2) requires the notice from the payer to include “the basis on which that amount was calculated”.

Recommendation

2.3.4 The group was unable to reach a consensus conclusion.

2.4 The current exception provided by the legislation to allow the use of pay-when-paid clauses in cases of insolvency

The Issue

2.4.1 “Pay-when-paid” clauses were made ineffective under the original Act (Section 113) with the exception of such clauses in cases of “upstream” insolvency. An insolvency of this kind is one where the payment can be withheld on the basis that the payer or another party contracted further up the supply chain has become insolvent leaving no finance for the payment to be made until after the assets of the insolvent firm have been administered.

Potential Solutions

2.4.2 The group discussed the proposal to remove the current exception in Section 113 of the Act, which allows pay-when-paid clauses to be effective in the case of an upstream insolvency. The review has concluded that there is no alternative measure to address this issue either this exception should remain or be removed.

2.4.3 The two main arguments in favour of removal are:

- that the risk of insolvency can best be managed by contracting parties and not by parties upstream or downstream of a potential insolvency.
- that it would have the effect of reducing the costs of insurance to cover the risk of insolvency.

2.4.4 At present, insurance against upstream insolvency is costed on the basis that it needs to cover the payee for the case of insolvency anywhere upstream where “pay-when-paid” clauses might apply. Typically an insurer might charge two or more premiums to cover this risk. The group recognised the advantages of insurance against upstream insolvency though greater use might also give rise to increasing costs of the construction product.

2.4.5 The group agreed that scope to manage an insolvency risk was relatively limited whether or not the proposal to eradicate “pay-when-paid” clauses for insolvency were implemented. Finally, the group considered the possible “domino” effect of a contractor forced to take on the whole risk of an upstream insolvency. This was considered a natural consequence of any added emphasis on individual risk management.

Recommendation

2.4.6 The group was unable to reach a consensus conclusion.

2.5 Commencement of the payment process

The issue

2.5.1 At present the Act provides that contractors are “entitled to payment by instalments, stage payments or other periodic payments for any work under the contract” (109(1)). This is balanced by the provision that “the parties are free to agree the amounts of the payments and the intervals at which, or circumstances in which, they become due” (109(2)). Section 109(1) does not relate to time of payment and so commonly, payments do not begin until work begins on-site. Preconstruction works and prefabrication are not then covered.

Proposed solutions

2.5.2 Discussion considered the effect of requiring that work in advance of arriving on-site should be covered by stage payments. A further proposed solution was that the legislation simply make clearer that “any work” might include work in advance of arriving on-site.

2.5.3 A full proposal, which was put to the group by the NSCC, consisted of:

- an amendment to clarify the meaning of the right to stage payments contained in the Act in order to make clear that they could cover work off-site.
- an amendment to the scheme which would substantially alter the application of the right to stage payments under the Scheme so that they would cover work off-site.

2.5.4 The shift in the Scheme was thought to be problematic by some on the group particularly for inexperienced and first time purchasers of construction as it could introduce problems of ownership of the materials being procured and worked upon. The payer would no longer have the security of knowing that the work was already on site and within his ownership and was of the right standard and specification before the payment was made.

Recommendation

2.5.5 The group was unable to reach a consensus conclusion. This may be a matter that can be dealt with effectively in guidance.

2.6 Length of payment periods

The issue

2.6.1 The parties are free to agree the amount of time that should elapse between the “due date” at which the payment due should be determined and the final date for payment. Some agreements appear to have made this intervening period as long as 180 days.

Potential solution

2.6.2 A “longstop” period in the Act was suggested to prevent the agreement of unreasonably long payment periods.

2.6.3 The group recognised that the “longstop” period could become the standard practice for some in the industry who might increase their payment periods up to this maximum. This would have the additional disadvantage of undermining the current flexibility for the whole chain to maintain a planned cash-flow arrangement through the agreement of appropriate due dates and final dates.

Recommendation

2.6.4 Though the group was concerned about lengthening payment periods in the industry, some members felt that there was little scope to do anything in the legislation, especially as lengthening periods are often due to payment abuse rather than contractual agreement. The group was unable to reach a consensus conclusion.

2.7 Right of suspension to include entitlement to losses and expenses during suspension period

The issue

2.7.1 Section 112 of the legislation provides a right for contractors to suspend performance under the contract where payment is withheld beyond the final date for payment and no withholding notice is served.

2.7.2 There is often a cost to suspending performance, as well as a cost of remobilisation, which can act as disincentive to the exercising of this right. Furthermore, remobilisation is required immediately when the payment is finally made, in spite of necessary delays for some contractors (for reasons of public health and safety etc).

Potential solutions

2.7.3 It was generally agreed that the statutory right to suspend performance under the contract should be supplemented with a right to reclaim the costs of suspension and remobilisation. Furthermore it was agreed that an appropriate delay should be provided for remobilisation once the payment in default is finally made.

2.7.4 Though supportive of the change in the legislation the concern was raised that the costs of suspension and remobilisation should only fall to the payer when he is genuinely in default. It was generally agreed that there should be no barrier to rejecting a fraudulent claim and seeking possible damages for breach of contract where the suspension was unjustified.

Recommendation

2.7.5 The group therefore recommends that:

- The right should be supplemented by a right to reimbursement by the payer of the costs of suspension and remobilisation.
- The right should cease an appropriate period of time after the payment in default is eventually made, rather than immediately after it is made as is currently the case.

2.7.6 It would be important to make sure that these costs fall to the payer only in those cases where the right to suspend had been exercised appropriately and the payer is genuinely in default. There should be no barrier to a payer rejecting a fraudulent claim for the costs of suspension and remobilisation and seeking possible damages for breach of contract where and suspension had been unjustified.

2.8 Cross contract set-off

The issue

2.8.1 Sir Michael Latham's original report, *Constructing the Team*, made the recommendation that "Cross contract set-off" should be legislated against. The group understands that increasing numbers contracts make provisions allowing the paying party to set-off claims under one contract against payments to be made under another. Clients argue that a smooth running project can be disrupted by cross contract set-off, while contractors believe it leads to uncertainty and difficult disputes. The working group is agreed that cross contract set-off is detrimental except in special circumstances.

Potential solutions

2.8.2 The Working Group discussed removing any right of cross contract set-off under construction contracts. It was generally agreed that the prohibition should not extend to the common law right of equitable set-off, which was regarded as less onerous to the payee.

2.8.3 Clients and contractors also wished to retain the right to set-off across contracts which were closely associated but where it was not clear whether a right of equitable set-off would arise, for instance under a framework agreement.

Recommendation

2.8.4 It was agreed that cross contract set-off should be prohibited but that this should not extend to rights of equitable set off. It was agreed that an exception to the prohibition should also be provided for contractual provisions on set-off between other closely associated contracts such as those under a framework agreement.

2.9 Security of payment under construction contracts

The issue

2.9.1 The specialist subcontractors have suggested that the Construction Act could be used to introduce a right for contracting parties to seek security of payment. This would allow them the guarantee that they would be paid in cases of insolvency.

Potential solutions

2.9.2 The working group has considered a number of the solutions put to it to provide guarantees of payment. These include:

- The use of an escrow account in which to suspend a proportion of the contract sum to be agreed at the outset of the project to be held for payments to the payee in the event of non-payment or insolvency;
- The right of the payee to require a bond from the payer in the event of non-payment;
- Providing the right of the parties to agree (or of the payee to require) the nomination of a third party payer in the event of non-payment or insolvency.

2.9.3 It was questioned whether solutions of this kind represent inappropriate forms of risk transfer. This is because they do not encourage the management of the insolvency risk all contractors generally accept when entering into commercial relationships. The group agreed that the effect of some of these measures would be to force the tying up of capital unnecessarily.

2.9.4 However there is an extent to which risks of insolvency are not wholly manageable once contracts are entered into. Furthermore there are cases where the current right of suspension is of little value in securing an unpaid contractors cash position.

2.9.4 A proposal which gained broad support was the provision of a right for a third party payer (usually the client or payer immediately up the contract chain) to make payments to payees who would otherwise go unpaid as a result of a payer's insolvency. The effect of this would be to overturn the judgement made in the 1975 case of *British Eagle International Airlines vs Compagnie Nationale Air France* which set the precedent that any payment for work done under a contract with an insolvent firm must be made to the firm's receivers even if the client preferred to pay the subcontractor who had actually done the work directly to make sure the subcontractor was paid.

Recommendation

2.9.6 A right should be provided for a third party payer to pay all or some of the unpaid funds to the payee in cases where the original payer is insolvent.

2.10 The Scheme for Construction Contracts

Recommendation

2.10.1 The group agreed that in making the necessary consequential amendments to the Scheme for Construction Contracts resulting from the amendments it had agreed to primary legislation, the government ought also to consider the possibility of simplifying the payment structures in the Scheme to ensure they were comprehensible to contractors seeking to employ them.