

# Construction Brief

## Spring 2010



## Welcome

Welcome to the Spring Edition of Construction Brief. We have a real potpourri of articles for you in this edition, from a further examination of the payment provisions under the soon to be enacted Construction Act to our usual examination of recent cases concerning adjudication in the TCC. Adjudication remains the primary method of dispute resolution in the construction and maintenance sectors and its prominence will only increase when the new Construction Act is enacted, making it available for oral contracts for the first time. The Construction Team at Devonshires are delighted to welcome back Mr Jonathan Lewis to this edition with a typically articulate examination of a recent case in the TCC concerning enforcement of an adjudicator's decision. We are seeing a marked reluctance on the part of some TCC judges to resist the enforcement of adjudicator's decisions and this area of jurisprudence

remains fluid. In July of this year we will be running a series of seminars in conjunction with Navigant Consulting on delay and disruption in construction contracts. Invitations will be with readers shortly.

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# Payment Provisions Revisited – Will the Proposed Changes to the Construction Act Benefit the Construction Industry?

## Background

In the early 1990's the Government commissioned an investigation into payment abuse and confrontation which characterised the construction industry. Sir Michael Latham prepared a report published in July 1994 under the title *Constructing the Team*. Following this report the *Housing Grants, Construction And Regeneration Act 1996* ("HGCR") came into force to deal with the industry's problems. Part II of the HGCR deals with construction, and is commonly referred to and known as the Construction Act. The HGCR governs the current position in relation to payment and disputes for construction contracts. The basic aims of the HGCR are:

- The provision of a swift and quick fix adjudication system.
- The abolition of "pay when paid" clauses.
- The use of proper and enforceable payment terms in construction contracts.

A commencement order is required to bring into force the LDEDCA. No date has been set for this, as the LDEDCA will not come into force before the construction industry has been consulted on the draft amendments to the *Scheme for Construction Contracts (England and Wales) Regulations 1998*. The consultation is anticipated in early 2010, and the industry awaits the outcome. However, there is a possibility that the reforms will be overtaken by the general election.

The HGCR covers the vast majority of building contracts and consultants appointments in the UK, so any changes will have far reaching implications.

## Proposed Changes to the Payment Provisions

Under the HGCR every construction contract is required to provide (i) an adequate mechanism for determining when and what payments are due under the contract; and (ii) a final date for payment of any sum which becomes due. There are also detailed requirements in relation to issuing payment notices, and a prescribed procedure is to be

2 *"The HGCR covers the vast majority of building contracts and consultants appointments in the UK, so any changes will have far reaching implications."*

- The prior notification of set-offs and contra charges.

Where a construction contract does not comply with the requirements of the HGCR, the relevant terms required in the contract will be implied in accordance with the provisions of the *Scheme for Construction Contracts (England and Wales) Regulations 1998*.

Due to continuing concerns about the consequences of unreasonable delays in payment under the existing HGCR, the *Local Democracy, Economic Development and Construction Act 2009* ("LDEDCA"), which amends the HGCR, received royal assent on 12 November 2009. The changes in respect of payment are intended to bring more transparency to the amount the payer intends to pay at the outset of the payment cycle. However, whether this clarity has been achieved is doubtful as the drafting is not straightforward.

followed if a party intends to withhold payment.

The LDEDCA will still require an adequate mechanism for payment. However, the provisions relating to payment notices will change significantly after the LDEDCA comes into force. Key changes to the payment provisions include the following:

## New Payment Notices

Section 143 of the LDEDCA adds two new Sections to the HGCR (Sections 110A and 110B). These Sections require new payment notices in place of the current Section 110(2) notice. The new provisions mean that a construction contract would have to require the "payer" or the "payee" to issue a new form of payment notice which would have to specify: (i) the sum the payer or payee considers is due, or was due, at the payment due date; and (ii) the basis on which that sum was calculated. In practice, many standard form contracts will use their existing payment mechanisms to ensure that an interim certificate

complies with Section 143 of the LDEDCA.

A problem for contractors and consultants with the HGCR is that there is no sanction attached to a failure to serve a Section 110 payment notice. The LDEDCA seeks to address this by providing that if the payer (or specified person) fails to serve a Section 110A notice, then the payee may provide a payment notice. The “notified sum” is the amount specified in the payee’s “default notice” and the client is obliged to pay this unless a withholding notice has been served. Unless the payee gives a notice:

- it cannot validly suspend performance of “any or all of” its obligations under the construction contract for non-payment; and
- the payer is not obliged to pay the payee under the new Section 111 of the HGCR (S 144 of the LDEDCA).

If the payee has to give a payment notice in default of the payer’s notice, it should do so straight away, as the final date for payment will be

before the final payment date. The new section would require the payer to identify the amount being withheld and the basis on which that sum is calculated, even if the sum was zero.

### **The Elimination of Pay-When-Certified Clauses that Link to Other Contracts**

The HGCR prohibits “pay-when-paid” provisions, except in certain circumstances where a third party, on payment by whom the contract is conditional, is insolvent. The LDEDCA goes one step further, and extends this to pay-when-certified provisions. The LDEDCA prohibits provisions that determine what payments are due and when by reference to the performance of obligations under another contract (or a decision by any person as to whether obligations under another contract have been performed). The theory is that this will reduce the time it takes for sub-contractors to be paid. However, some sceptics argue that it will instead simply lead to employers agreeing longer final dates for payment.

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postponed by the number of days after the due date that any such notice is served.

Also, under the existing regime employers sometimes try to contractually delay the “due date” for payment to avoid their obligations under the HGCR. They do this by providing that the due date will not commence until they have given a payment notice to the payee. Section 142(3) of the LDEDCA (which introduces a new Section 110 (1D) to the HGCR) outlaws any payment procedure where the payer (or third party) decides when payment is due. However, a construction contract may still require the person who will be paid to give a notice.

### **The Replacement of Withholding Notices**

Section 144 of the LDEDCA replaces Section 111 of the HGCR. The regime has not changed much in that it is still necessary to serve a withholding notice a prescribed number of days

### **Enhancements to the Statutory Right to Suspend for Non-Payment**

Under the HGCR a party to a construction contract may suspend the performance of all of their obligations under the contract if they are not paid. However, the current right can only be applied to all obligations.

The LDEDCA will allow a party to suspend all or part of its obligations on a project. This could lead to an increase in contractors and consultants suspending. Rather than suspending all obligations they may suspend a particular obligation (for example, attending site meetings), until they are paid. In addition, the suspending party will also be allowed an extension of time for the suspension.

The LDEDCA will also require a payer who has not paid to pay a reasonable amount to the payee for the reasonable costs and expenses suffered by the payee, if it suspends its performance for non-payment.

Many standard forms already provide for an extension of time and loss and expense. However, these additional statutory rights are significant, and make suspension a much more powerful weapon, particularly for contractors.

### Conclusion

According to the Government's impact assessment, amendments to the "payment notice" requirements should save the construction industry approximately £5.8 million in administration costs per annum. The Government also estimated that improvements to the payment framework, to ensure contracts create clear and timely entitlements to interim payments, will save 1% to 1.5% on the average project. Reflected across the construction sector in England and Wales, this represents £1 to £1.5 billion.

However, if and when the LDEDCA does come into effect, the construction industry will need to familiarise itself with the new provisions, and ensure that their template contracts are revised

accordingly. JCT propose to produce a Revision 3 of their standard form of contracts once the LDEDCA comes into force.

Despite the potential savings outlined above, the changes mean this area will become increasingly complicated. Therefore, any potential savings will require an initial investment of time to update the relevant contracts and to understand and comply with the provisions.

For further information about any of the issues raised by this article, please contact a member of the Non-contentious Construction Department.

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## Enforcement of Adjudicator's Decision: The Test for Stay of Execution of Adjudicator's Decision

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In the recent case of *Anrik Limited v A S Leisure Properties Limited* the Court considered the possibility that an application for stay of execution of an Adjudicator's decision may, in some circumstances, require investigation into the merits of the underlying claim. Two important points arise from this case. The first is the date from which the court will assess a change in financial position on an application for a stay of execution of a Judgment to enforce an Adjudicator's decision. The second is whether the applicant for a stay of execution must first demonstrate an arguable case that the Adjudicator's decision was wrong.

### Facts

This case concerned an application by A S Leisure Properties Limited ("AS") for a stay of execution of an order for summary judgment in respect of an unsatisfied Adjudicator's decision pursuant to CPR Part 50.1 and RSC Ord. 47.1(1)(a). The underlying dispute before the Adjudicator

was whether the parties had entered into an enforceable contract in 2006 and if they had, whether Anrik Limited ("Anrik") was entitled to damages under that contract. In order to avoid any jurisdictional issues, the parties entered into an ad-hoc adjudication agreement pursuant to which an Adjudicator was appointed to determine the dispute. The ad-hoc adjudication agreement expressly incorporated the Scheme for Construction Contracts (England and Wales) Regulations 1998. The ad-hoc adjudication agreement was entered into 6 weeks before the Adjudicator's decision.

The Adjudicator decided that there was an enforceable contract and awarded Anrik a sum of £516,000 in damages. AS refused to satisfy the award but conceded that Anrik was entitled to summary judgment. AS applied to stay the execution of that Judgment and offered to pay the full award into court pending the determination of its claim in the Technology & Construction Court

("TCC") for a declaration that no enforceable contract had been entered into between the parties.

The basis of the application for a stay of execution was AS's claim that there was a real risk that Anrik would be unable to repay the Judgment sum in the event that it was ordered to do so at the end of the proceedings commenced by AS. AS argued that there had been a significant deterioration in the financial position of Anrik between the date of the alleged construction contract in 2006 and the date of the Adjudicator's decision in 2009.

Anrik argued that the court should not assess whether there had been deterioration in its financial position from the date of the underlying construction contract but from the date of the ad-hoc adjudication agreement. In *Wimbledon Construction Company 2000 Limited v Derek Vago* [2005] EWHC 1086 (TCC), HHJ Coulson QC (as he then was) held that even if it was probable that a party would not be able to repay

dispute, the parties had entered into the ad-hoc adjudication agreement and it was this agreement that created the contractual mechanism for the creation of the Judgment debt. The Judge held that there had been no change in the financial position of Anrik between the date of the ad-hoc adjudication agreement and the date of the hearing of AS's application for a stay of execution. AS's application was dismissed.

Interestingly, both in argument and in his decision the Judge held (albeit in *obiter*) that if he had been of the view that the Adjudicator's decision was unarguably correct then in the exercise of his discretion he would not have granted a stay of execution even if there had been a significant change in financial position between the date of the relevant contract and the date of the hearing. This appeared to introduce a threshold test to be satisfied by an applicant for a stay of execution.

No previous decision supports the imposition of such a test. It would also introduce a requirement in every case for the Court to investigate the

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the Judgment sum if so ordered, the court should not usually make an order for a stay of execution where the financial position was the same or similar to its financial position at the date of the relevant contract. Anrik argued that "relevant contract" for the purposes of the *Wimbledon* decision was the contract which gave rise to the Judgment debt. In the instant case this was the ad-hoc adjudication agreement and not the alleged underlying contract.

### Decision

The Judge accepted Anrik's submissions. He held that the "relevant contract" for the purposes of the *Wimbledon* decision was the contract which created the contractual mechanism giving rise to the Judgment debt. Normally this would be the construction contract which would in most cases expressly provide a dispute resolution mechanism or be subject to the Housing Grants Construction and Regeneration Act 1996. In the instant case, because of the underlying

merits of the underlying dispute and correctness of the Adjudicator's decision. This would inevitably result in very protracted applications. The imposition of such a threshold does not sit easily with the consistent decisions of the TCC and Court of Appeal supporting the proposition that the Courts should simply enforce adjudicator's decisions irrespective of whether the decision was right or wrong.

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# Procuring Maintenance Contracts

## - Comply with the Legislation or Face Problems

When procuring maintenance contracts there are numerous legal issues to consider, in particular section 20 consultation and public procurement. Section 20 requires leaseholders to be consulted before landlords carry out works above a certain value or enter into long term agreements for the provision of services. The public procurement regulations must be considered for larger contracts and public notices published in the Official Journal of the European Union (OJEU).

Section 20 consultation requires the landlord to state, by way of consultation notices, to both individual leaseholders or tenants and recognised tenants' associations "RTAs", why it considers the work to be necessary. After service of the notices it must respond to observations received from residents and RTAs. In certain circumstances the residents must also be invited to nominate alternative contractors and the landlord must try to obtain quotes from any such nominated contractors. However, this right of nomination does not apply where the public procurement regulations need to be followed to procure the contract. The

### Qualifying long-term agreements

These are any contracts or agreements relating to service charge matters entered into by a landlord or superior landlord for a term of more than twelve months. These are usually agreements affecting the building generally such as cleaning, gardening, lifts or entry phones. Ongoing contracts with no specific termination dates could also be included.

There are also **qualifying works under a qualifying long-term agreement**. These are works to be carried out under a long-term agreement which has already been consulted on. The fact that the long-term agreement has already been consulted on does not mean that the qualifying works are exempt from consultation. The procedure is a simplified version as the contractor has already been chosen and the leaseholders and RTAs may only comment on the nature and extent of the works.

### EU Procurement

Some landlords, especially Registered Providers, must also consider the public procurement thresholds when letting maintenance contracts. In

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consultation procedure varies according to whether a long-term agreement is involved or a works contract and whether the public procurement regulations apply to either. However, essentially all the different processes require two separate 30 day periods for residents and RTAs to make observations; landlords would be prudent to allow a minimum of three to four months for the whole process.

### What is subject to Section 20 consultation?

There are two main areas of service charge expenditure which are subject to consultation: "qualifying works" and "qualifying long-term agreements".

### Qualifying works

These are "works on a building or any other premises". Qualifying works would include repair works, maintenance or improvements.

some cases the contract sum, whether for qualifying works or long term agreements, will be of a level where the public procurement regulations apply. If so, the proposed contract must be advertised by public notice in the Official Journal of the European Union. With effect from 1 January 2010 the financial thresholds at which the public procurement regulations apply were raised to £3,927,260 for works contracts and £156,442 for services and supply contracts. Both amounts are exclusive of VAT.

Alongside the public procurement process landlords must also run the section 20 consultation process describing the works to be carried out and informing the leaseholders of its reasons for carrying out the works. If a contract is to be procured under the public procurement regulations, the landlord does not have to invite nominations for contractors from residents as public notice will be given.

## Non-Compliance

The principal purpose of section 20 consultation is to seek residents' opinions on the landlord's proposals. However, if the landlord does not carry out the full consultation process in the correct manner, it will not be able to collect or recover services charges above the statutory maximums - £100 per annum in relation to qualifying long-term agreements and £250 in respect of qualifying works. The landlord would have to cover the loss itself. Failure to comply with the public procurement procedure can result in challenges from unsuccessful bidders. Such challenges could be in the form of an injunction to prevent the award of the contract, damages for loss of profit and/or wasted tender costs or, for contracts procured on or after 20 December 2009, an action to get the contract declared to be "ineffective" by the court and therefore set aside.

There are several procedures involved in procuring maintenance contracts which must be carefully followed by landlords to ensure the contracts are successfully procured both from a public

procurement and section 20 perspective.

For further information about any of the issues raised by this article, please contact a member of the Non-contentious Construction Department.

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## Adjudication – Jurisdiction in Complex Cases

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In the recent case of *Enterprise Managed Services Ltd v Tony McFadden Utilities Limited* [2009] EWHC 3222 (TCC) 2 December 2009, the Court considered whether an adjudicator can determine a claim brought by a sub-contractor's assignee against a replacement contractor. The assignee claimed the net balance due between an insolvent sub-contractor and a creditor involved in mutual dealings for the purpose of Rule 4.90 of the Insolvency Rules 1986. The Court also considered the suitability of adjudication for complex cases.

### The facts

By way of contract dated 5 May 1998 Thames Water Utilities ("TWU") engaged Thames Water Services trading as Subterra ("Subterra") to carry out the repair and maintenance of mains, service pipes, and other fittings (the "Main Contract"). Under a subcontract dated 13 November 2002 with Subterra, Tony McFadden ("TML") agreed to carry out these works (the "Subcontract"). The Subcontract was a construction contract for the purposes of adjudication under the Housing Grants (Construction &

Regeneration) Act 1996 (the "Act").

On 31 August 2003 Enterprise Managed Services ("Enterprise") bought Subterra. An asset purchase agreement and novation agreement were duly entered into. The deed of novation listed only the main contract. Enterprise proceeded to make payments to TML.

In April 2004 the final account was disputed and the sub-contract was terminated because the main contract had been terminated. Between 2005 and 2006, EMSL engaged TML on a further contract and two other minor contracts including a small van hire sub-contract. There were claims of over £5million by TML and a claim for overpayment in the sum of £3 million by EMSL on the two principal contracts.

In May 2006, TML went into administration and in June 2009, the liquidator assigned "the Net EMSL Balance" to Tony McFadden Utilities Limited (TMU). On 21 September 2009, TMU wrote to EMSL advising them that they had taken assignment of the rights of TML against EMSL arising out of, amongst other things, what had been the Subterra contract and then issued

a notice of adjudication in relation to the dispute under that contract alone.

### Halting the adjudicator

TMU commenced adjudication in September 2009. On 27 October 2009 Enterprise issued CPR part 8 proceedings seeking declaratory relief that the Adjudicator had no jurisdiction to proceed to reach his decision.

TMU argued that what had been assigned to it was the balance due on the account pursuant to Rule 4.90 of the Insolvency Rules 1986. TMU claimed that the assignment enabled TMU to commence an adjudication in respect of one contract that might contribute to the calculation of that net balance but would not in itself determine the net balance.

The Court held that the Adjudicator did not have jurisdiction in relation to the claim brought by TMU against EMSL and that a declaration should be made to abort the ongoing adjudication. The Court held that although the underlying actions in relations to the claims and cross claims arising from each dealing

course of the adjudication. The original timetable for the Adjudicator to reach a decision had been extended to 13 weeks. Adjudicators should be discouraged from permitting 'creep' whereby piecemeal extensions of time for further submissions amount to a protracted adjudication process. These extensions of time gave the Adjudicator less time to fairly consider the dispute. Considering *AWG-v-Rockingham and CIB Properties Ltd v Birse Construction Ltd*, Mr Justice Coulson stated that if an adjudicator cannot reach a decision fairly within the time limit prescribed by the Act, then he should resign. On the facts of this case and the nature of the dispute, this case was not suitable for adjudication.

### Conclusion

It was clear to the Court that TMU's disputed final account claim was extensive, complex and paper heavy, not suitable to being determined within the normal 28 day period for the adjudication process under the Construction Act. The Adjudicator should have properly ascertained the likely scope and nature of the dispute from the outset. At this point, it would have been clear

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have to be determined to assess the net balance, the choses in action in each case cease to exist upon the assignment of the net balance and only the net balance is actionable. Therefore where the parties are involved in multiple mutual dealings leading to a net balance, these cannot be dealt with by an adjudicator for the purpose of Rule 4.90.

The Court held that only the right to the net balance had been assigned to TMU. TMU did not have the right to adjudicate only in relation to the first contract as this would not lead to the determination of the net balance and that this claim could only be pursued in court. Absent agreement between the parties, only one dispute can be adjudicated at a time. The fact that the van hire contract was not a construction contract meant that the adjudicator would not even have jurisdiction to consider it.

Mr Justice Coulson expressed strong views about the

that given the nature of the dispute he could not have carried out his role fairly within the timeframe. Although he was not able to make a binding decision on his own jurisdiction, undertaking such an exercise it would have been clear to him that the adjudication process was not suitable. The position would have been different if the parties had agreed the Adjudicator's timetable.

Arguably, the case allows for further jurisdictional 'hi-jack' of the adjudication process. It is open to a responding party to present voluminous and complex submissions relating to the issues in dispute. This makes the likelihood of ultimate enforcement more unlikely since the Responding Party may well argue that the adjudicator failed to comply with rules of natural justice. On the other hand, if an adjudicator resigns and there are no further appointments, the likely and more costly alternative will be to commence proceedings at the Technology and Construction Court.

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