



**IMPROVING PAYMENT  
PRACTICES IN THE  
CONSTRUCTION INDUSTRY**

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

MARCH 2005



Llywodraeth Cynulliad Cymru  
Welsh Assembly Government



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## **Improving payment practices in the construction industry – 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**

### **Explanation of the wider context for the consultation and what it seeks to achieve**

These consultation proposals are drawn from Sir Michael Latham's recent review of the operation of Part II of the Housing Grants, Construction and Regeneration Act 1996 and the Scheme for Construction Contracts (England and Wales) Regulations 1998.

This consultation is a joint exercise between the DTI and Welsh Assembly Government covering the primary and secondary legislation in both jurisdictions. It is intended to build a general consensus on the way forward. Should clear support for changes to the legislation be identified, there will then be consultation on draft amendments.

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**Response deadline: 21 June 2005**

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# Foreword

**By Nigel Griffiths MP, Parliamentary Under Secretary of State for Construction, Small Business and Enterprise**

Fair payment practice is something everyone agrees with. However, I regret that the construction sector does not speak with one voice on how to achieve it. What constitutes fair payment is the subject of considerable debate and views differ depending where a firm may feature in the construction supply chain.

At my request, following the announcement of a review of the Construction Act in the 2004 Budget, Sir Michael Latham convened and chaired a review group to consider the key issues that affect payment in the construction industry under the Construction Act. I am extremely grateful for all Sir Michael's efforts, and those of his working group chairmen, Richard Haryott and Graham Watts. I am also grateful for the positive contributions that all parties in the industry and the legal profession have made to the review.

Sir Michael's report is a valuable piece of work and has raised some key issues. Broadly these congregate around the key principles of improving the ability of people in the industry to agree what should be paid and when, improving the ability of people to manage cash flow and reducing the disincentives to refer disputes to adjudication. No one can rightly challenge that these principles are the correct ones. They underpin several of the key aspects of maintaining and improving the effectiveness of the contracting process. This consultation provides the opportunity for the whole industry and its clients to come together around a shared set of proposals. A fair payment culture underpins any progressive and modern industry. I would urge you not to squander the opportunity in front of you.

# Endorsement

## **From Edwina Hart AM Welsh Assembly Government Minister for Social Justice and Regeneration**

Cash flow is the lifeblood of the construction industry, central to the sustainability necessary to deliver in accordance with our needs and aspirations. It is however clear that there are serious issues arising from current payment practices in the construction industry. During a period in which investment in national infrastructure and local communities is increasing, it is vital to maintain a healthy commercial environment in which the industry can prosper.

The Construction Act sets a fine balance between the legitimate, but sometimes conflicting, needs of smaller and larger construction firms within the supply chain. We are looking to consultees to use their breadth of experience and expertise to help identify a way forward around which we can all unite.

I would urge all respondents to consider the issues raised and how they might be addressed for the benefit of the industry, its clients and the wider community.

# Executive Summary

Sir Michael Latham's review of Part II of the Housing Grants Construction and Regeneration Act 1996 and the Scheme for Construction Contracts (England and Wales) Regulations 1998 was announced in the 2004 Budget and published by the DTI in September 2004. The review looked at the effectiveness of the legislation in achieving its aims of facilitating cash flow down the construction supply chain and enabling the effective completion of construction projects. Sir Michael's review found that the Construction Act is generally working well but some improvements would be helpful if means could be found to deliver them without adverse impacts on other parties or other elements of payment processes.

The proposals in this consultation are aimed at improving the ability of parties to a construction contract to:

- reach agreement on what should be paid and when given the work done under the contract or, where they cannot agree, to make an informed referral to, or response at, adjudication;
- manage cash flow and enable completion of work on the project in the event of problems such as defaulted payments, disputes or insolvencies elsewhere in the supply chain; and,
- refer disputes to adjudication without disincentives such as avoidance, frustration or unnecessary challenge.

This initial consultation with the construction industry and its clients asks for views on:

- whether the right issues have been identified;
- whether the right solutions have been proposed or whether there are other options; and,
- how we might evaluate the potential costs and benefits of the different proposals.

## Chapter I – Payment framework

*Improving the ability of the parties to a construction contract to reach agreement on what should be paid and when given the work done under the contract or, where they cannot agree, to make an informed referral to, or response at, adjudication.*

1. **Defining the content of an adequate payment mechanism in Section 110(1) of the Construction Act** – We believe the mechanism should be required to include terms on what amounts constitute the payment under the contract; when a payment is to be assessed under the contract; how the amounts are to be determined; the period of time that should elapse from the "assessment date" before the final date for payment; and what information is to be communicated between the parties.
  - Do you agree that payment framework under the Construction Act would benefit from the inclusion of a definition of what should constitute an adequate mechanism for payment?
2. **Removing the requirement to serve a Section 110(2) notice in the Construction Act**
  - Do you agree that the requirement in Section 110(2) should be removed and that in its place the legislation should clearly define what is meant by "an adequate mechanism for determining what payments become due under the contract, and when"?
3. **Providing an application for payment in the legislation** – We have proposed an application process which might be appropriate for inclusion in the Construction Act alongside the "adequate mechanism" and available as of right to payees.
  - Do you believe that an application should be available for a payee to submit as of right alongside the operation of the contractual payment mechanism if necessary?
  - Do you agree that in this context the application should not create an entitlement to the amount applied for?
4. **Redefining the content of withholding notices under Section 111** – We propose that the legislation should require all withholding notices to state the remaining amount that the payer intends to pay after withholding the amount notified.
  - Do you agree that the legislation should be changed to require that a Section 111 notice provides details of the final amount to be paid?
5. **Restricting the use of pay-when-certified clauses** – We propose that under all contracts containing these clauses a copy of the certificate should be passed to the subcontractor whenever payment becomes due and that under a "pay-what-certified" clause the work should be priced as an individual element in the certificate.
  - Do you agree?

## Chapter II – Other payment proposals

*Improving the ability of the parties to a construction contract to manage cash flow and enable completion of work on the project in the event that problems arise for reasons outside of their control such as defaulted payments, or disputes or insolvencies elsewhere in the supply chain.*

6. **Introducing a right to reimbursement for the costs of suspension and remobilisation and providing additional time for remobilisation under Section 112 of the Construction Act**
  - Do you agree that it is necessary to supplement the existing right to suspend performance in this way?
7. **Making contractual provisions on cross contract set-off ineffective**
  - Do you agree that the existing common law right of "equitable set-off" is sufficient for the needs of the construction industry?
8. **Making "pay-when-paid" clauses ineffective in cases of "upstream" insolvency proceedings**
  - Do you agree with our conclusion that there is no evidence that the removal of the current exception to the prohibition of "pay-when-paid" clauses would deliver a fairer outcome for the construction industry overall?
9. **Allowing stage payments under the Scheme for Construction Contracts to be made for materials in advance of their arrival on site**
  - Do you agree that, in order to improve cash flow down the contract chain, and given the growth in off-site fabrication, the Scheme should provide for stage payments for materials, and work on their preparation off-site?

## Chapter III – Adjudication proposals

*Reducing the disincentives to referring disputes to adjudication where it is suitable. The review has suggested these might include avoidance or frustration of the process or outcome, unnecessary legal challenge or unpredictable or excessive costs.*

10. **Preventing the use of "trustee stakeholder accounts" to suspend an adjudicator's award pending litigation other than when the recipient is involved in insolvency proceedings**
  - Do you agree that trustee stakeholder accounts should only be available to suspend adjudicator's awards in cases where the payer is involved in insolvency proceedings?
11. **Providing the adjudicator with the power to rule on certain aspects of his own jurisdiction and providing a right to payment in cases where the adjudicator stands down due to lack of jurisdiction**
  - Do you agree that adjudicators could be expected to make correct and reliable decisions on whether there is a construction contract between the parties, whether there is a dispute and whether he has been properly appointed?
12. **Providing the adjudicator with the right to overturn "final and conclusive" decisions where these are of substance to interim payments only**
  - Do you agree that the Construction Act should allow this?
13. **Extending the adjudicator's immunity under the Construction Act to claims by third parties**
  - Do you agree that adjudicators should be provided with statutory immunity like that provided to arbitrators?
14. **Applying provisions on adjudicator independence from the Scheme for Construction Contracts' to all adjudications in Section 108 of the Act**
  - Do you agree that applying a "double test" of independence in addition to impartiality of adjudicators will allow greater security that the process is being conducted fairly?

# How to respond to this consultation

A consultation response form is contained in Annex 4 of this document. It contains what we consider to be the most important questions asked at the end of each of the sections of this consultation paper. However, it does not ask all of the questions that we are seeking answers to. Where a particular issue or proposal is of specific interest or concern to you, we should be grateful if you would answer all of the questions in the relevant section of the consultation as fully as possible. Please feel free to make as many additional comments or suggestions as you feel are appropriate, and to ask whatever questions concern you.

Each section contains two sets of questions. The first set, under the heading "Consultation questions" explores views on the issues and proposals and allows you to contribute to, and influence, continuing policy development.

The second set of questions, under the heading "Regulatory impact", is designed to help us identify the impact of the various issues and proposals on the industry and its clients and to inform the Regulatory Impact Assessment that will be needed if we go forward with legislation. Detailed and reliable information has been very hard to come by and, whilst we appreciate that this may be difficult, we should be very grateful if you would answer as many of these questions as you are able to. Your responses will enable us to assess whether the proposals deliver better payment practices than the legislation as it currently stands.

This is a joint consultation between the DTI and the Welsh Assembly Government. The Welsh Assembly Government has responsibility for policy on the Construction industry in Wales. If your organisation covers Wales or if you are aware of any issues related to these proposals which have a specific impact in Wales we should be grateful if you would explain.

Though we cannot respond individually to each consultation response, we will publish an analysis of consultation responses, and our response to the consultation findings, following completion of this exercise.

An electronic version of the consultation response form will be available via the internet at:

<http://www.dti.gov.uk/construction/hgcra/hgcralead.htm>

## **Response Address**

All responses should be sent to:

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Copies of all responses will be forwarded to the Welsh Assembly Government.

## **Additional Copies**

You may make copies of this document without seeking permission. Further printed copies of the consultation document can be obtained from:

DTI Publications Order Line  
ADMAIL Publications  
London SW1W 8YT

Tel: 0845 015 0010

Fax: 0845 015 0020

Minicom: 0870 1502 100

[www.dti.gov.uk/publications](http://www.dti.gov.uk/publications)

Copies of the consultation document in Welsh are also available from this address.

An electronic version can be found at:

<http://www.dti.gov.uk/construction/hgcra/hgcralead.htm>

and,

<http://www.wales.gov.uk/keypubconsultation/index.htm>

A Welsh electronic version can be found at the same address.

Other versions of the document in Braille, other languages or audio cassette can be requested from:

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### **Confidentiality**

Your response will be made public by the DTI and the Welsh Assembly Government. If you do not want all or part of your response or your name made public, please state this clearly in the response. Any confidentiality disclaimer that can be generated by your organisation's IT system or included as a general statement on your fax cover sheet will be taken to apply only to information in your response for which confidentiality has been requested.

We handle any personal data you provide appropriately in line with the Data Protection Act 1998.

### **Help with queries**

Questions about the policy issues raised in the consultation document should be addressed to:

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If you have comments or questions about the way in which this consultation has been conducted, these should be sent to:

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A copy of the Cabinet Office Code of Practice on consultation is contained in Annex 3.

# Introduction

The Government's review of Part II of the Housing Grants, Construction and Regeneration Act 1996 ("the Construction Act") was announced in the Budget on 17 March 2004. The Budget report 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 of Part II of the Housing Grants, Construction and Regeneration Act 1996 to identify what improvements can be made."

On 1 April 2004 the Construction Minister, Nigel Griffiths MP, appointed Sir Michael Latham to undertake the first stage of the review. Sir Michael's review group quickly appointed two working groups to undertake the review. Richard Haryott was asked to chair the group looking at the payment provisions of the legislation while Graham Watts chaired a group, drawn largely from the Construction Umbrella Bodies Adjudication Task Group, to look at the operation of the adjudication provisions.

Sir Michael Latham's review was published on 17 September 2004. The review proposals affect both primary and secondary legislation, largely in Part II of the Housing Grants Construction and Regeneration Act 1996 and The Scheme for Construction Contracts (England and Wales) Regulations 1998 (Statutory Instrument 1998 Number 649 – "the Scheme"). The working groups had discussed a large number of proposals but could not always agree a recommendation, leaving some issues that had been raised unresolved. This consultation paper considers many of those proposals, whether resolved or not. It also considers some new proposals which, it is hoped, might generate greater consensus than some considered in the review to address the very complex issues that were raised.

## **Proposals not being considered as part of this consultation**

There are a number of proposals and issues, which were raised in the review on which we are not formally consulting although we will consider any responses relating to them. Our reasons for deciding not to consult on these proposals are set out in Annex 2. The proposals fall largely under the following headings:

- Proposals to amend the scope of application of the legislation (announced in Nigel Griffiths' letter to Sir Michael Latham of 21 October 2004).
- Issues previously consulted on in "Improving Adjudication in the Construction Industry" (see below).
- Proposals where clarification of the existing law could be helpful but is not actually necessary and could be covered through guidance if needed.

- Proposals to legislate to introduce measures for construction contracts affecting the framework of other late payment or insolvency legislation relating to all industry sectors.

Additionally we do not intend to consult on amending Section 107 of the Construction Act following the decision of the appeal court on the application of the legislation to "contracts evidenced in writing".

### **Improving adjudication in the construction industry**

In 2001 the then Department of the Environment, Transport and the Regions published the consultation paper "Improving Adjudication in the Construction Industry". A parallel consultation took place in Wales. That consultation considered a large number of amendments to the Scheme for Construction Contracts, originally proposed by what later became the Construction Umbrella Bodies Adjudication Task Group. The conclusions of that process resulted in the publication by the task group of "Guidance to Adjudicators" and the "Users Guide to Adjudication" which have been very warmly welcomed. Only one amendment to the legislation relating to the costs of the adjudication process was identified as necessary following the consultation.

We have now finalised legislative proposals on the costs of the adjudication process. The planned legislation would:

- set a basic position that the parties to an adjudication should bear their own legal and other costs while the costs of the process (the adjudicators fees and expenses and the costs of his appointment) are referred to the adjudicator to be decided as part of his decision of the dispute.
- provide that any agreement in the contract between the parties with an effect other than that described above will be ineffective.
- provide that, once a dispute has been referred to an adjudicator, if both parties also wish to refer the legal costs they incur in the process, the adjudicator should also award these as part of his decision of the dispute.

We intend to take forward this legislative change along with any amendments to the Construction Act and Scheme resulting from this consultation. As always these legislative proposals will be subject to the usual pressures of the parliamentary timetable.

## **Consultation process**

This consultation focuses on the significant issues affecting the construction industry's performance on payment and its ability manage the contracting process in a fair way as far as payment is concerned. At the end of the day, only teamwork across the construction team, taking a positive approach to problem solving and respecting all in the supply chain can deliver fair payments at all times in all circumstances. However, this consultation does offer the opportunity to address what appear to be significant issues faced by many in the construction industry and significantly improve the effectiveness of the construction contracts legislation.

Each section of the consultation document raises a number of issues that concern the DTI and Welsh Assembly Government and makes proposals on how we might move forward to address these issues more effectively. This consultation is being taken forward jointly by the Department of Trade and Industry and Welsh Assembly Government and covers England and Wales.

In commenting on these proposals, please take into account not only the impact on your company, or your part of the supply chain, but that of others in the construction team. We are looking for proposals that, overall, have a positive impact on the fairness of payments and not for proposals that simply shift risk and reward around the team members.

It will be for the devolved administrations in Scotland and Northern Ireland to consider whether to undertake similar consultation processes recognising the differences in legislation and the law that exist within their respective jurisdictions.

Finally, as with the drafting of the legislation, this consultation repeatedly refers to "the adjudicator", "the certifying officer" or one of the contracting parties as "he". In this context the masculine is intended to include the feminine and should not be seen as any reflection on the current gender balance of the construction industry.

# Chapter I – Payment framework

*Improving the ability of the parties to a construction contract to reach agreement on what should be paid and when given the work done under the contract or, where they cannot agree, to make an informed referral to, or response at, adjudication.*

## 1. Defining the content of an adequate payment mechanism in Section 110(1) of the Construction Act.

### The issue

- 1.1 The review recommended that the requirement for an adequate payment mechanism in Section 110(1) of the legislation should be revised so as to define the features that should constitute "an adequate mechanism".
- 1.2 The review further suggested that the definition of the features of the adequate mechanism created potential benefits in other areas, for instance by allowing for the removal of Section 110(2) and tackling some "pay-when-certified" issues. These points are picked up in subsequent sections of this consultation document.

### Current legislation

Section 110(1) reads:

*Every construction contract shall-*

- (a) provide an adequate mechanism for determining what payments become due under the contract, and when, and*
- (b) provide for a final date for payment in relation to any sum which becomes due.*

The parties are free to agree how long the period is to be between the date on which a sum becomes due and the final date for payment.

### Proposed way forward

- 1.3 We support the review's recommendation that, in order to be "adequate" all contracts should be required to include terms stating:
  - What amounts constitute the payment under the contract;
  - When a payment is to be assessed under the contract;
  - How the amounts are to be determined;

- The period of time that should elapse from the point the payment is to be assessed (the "assessment date") before the final date for payment;
  - What information is to be communicated between the parties (who provides what, to whom and in what level of detail during the process).
- 1.4 Although several features of the mechanism set out above would seem to be implicit in the current wording of the legislation, the more systematic approach should enable contracting parties to check in advance that the contractual payment mechanism will be adequate and will allow all parties, whatever their bargaining power, to require vital information on the mechanism to be included in the contract.
- 1.5 The proposal allows flexibility for further terms to be included in contracts relevant to specific circumstances. It leaves it to the parties to decide what the mechanism needs to be to respond to the points in 1.3. We believe this is a more flexible approach than that currently provided by Section 110(2). The proposed mechanism should enable:
- the payee to know the amount the payer understands to be due under the contract and the date the payer understands will be the final date for payment under the contract;
  - the process to be completed by up to five days after the "assessment date";
  - the payee to establish the amounts constituting the payment, should he wish to; and,
  - access to adjudication if the mechanism is not operated as agreed in the contract.

### **Scheme for Construction Contracts**

- 1.6 We believe that the current payment mechanism (including the current payment notice) in Paragraphs 2 – 9 of the Part II of the Scheme for Construction Contracts satisfies all of the above requirements for an adequate mechanism. As such, we consider that the payment mechanism in the Scheme will not require any amendment in parallel with that proposed for the Construction Act.

### **Alternative proposals**

- 1.7 The review considered and rejected the inclusion of two additional potential features of an adequate mechanism:

- **Provisions covering what happens in default of operation of the contractual mechanism** – Usually where a party is in default of operation of the contractual terms, the adjudication process in the Construction Act or Scheme already covers this requirement. Under this alternative proposal the parties would be required to agree an additional default provision specifically covering the period between the assessment date and the final date for payment in which an application for payment could be made. We believe adjudication provides a sufficient default mechanism.
- **Provisions setting out how entitlements (eg loss and expense and retention) are to be determined and paid** – We would expect these items to be covered as appropriate in contracts as a matter of course. We are not in favour of requiring these terms as part of an adequate mechanism as set out in the legislation.

We would nevertheless welcome views from consultees on whether such mechanisms are necessary and, if so, how they would operate and what benefits / costs they would generate.

### **Consultation questions**

- Q1.1** Do you agree that the payment framework under the Construction Act would benefit from the inclusion of a definition of what should constitute an adequate mechanism for payment? Please explain.
- Q1.2** Would providing guidance on what constitutes an adequate mechanism be more appropriate than changing the legislation?  
Please explain.
- Q1.3** Do you agree that the adequate mechanism should be expressly required to include terms stating:
- a) what amounts constitute the payment under the contract **(Yes / No)?**
  - b) when a payment is to be assessed under the contract **(Yes / No)?**
  - c) how are the amounts to be determined **(Yes / No)?**
  - d) the period of time that should elapse from the point of assessment of the payment is to be ascertained before the final date for payment **(Yes / No)?**
  - e) what information is to be communicated between the parties (who provides what, to whom and in what level of detail during the process) **(Yes / No)?**
- Please explain the reasons for your answers.
- Q1.4** We would expect failure to operate the contractual mechanism correctly to lead to an ability for the parties to refer a dispute to adjudication as currently. Do you agree that this should continue to be the case?

**Q1.5** We would expect any failure to agree specific features of the adequate mechanism to lead to an ability for the parties to fall back to the payment mechanism as currently set out in Part II of the Scheme. Do you agree that this should continue to be the case?

Please add any comments or justifications to your answers.

**Q1.6** Assuming that the requirement for an adequate mechanism in the Construction Act were included as proposed in paragraphs 1.3 – 1.5, do you agree that the mechanism in the Scheme for Construction Contracts satisfies all of the requirements of the payment mechanism as proposed? **(Yes / No – please explain what changes you believe would be needed)**

### **Regulatory impact**

1.8 The Construction Act already requires "an adequate mechanism for determining what shall be paid and when". We consider that amending the Construction Act to set out specific requirements for an adequate mechanism makes explicit an existing implicit requirement. Since we would expect to see these requirements in any well-written contract, we do not believe that it would impose a burden on industry or indeed clients. At most, therefore, they would impose a minor regulatory burden. The proposal could be considered to reduce an administrative burden by enabling parties to a contract to focus more closely on the key issues and not include unnecessary conditions.

**Q1(i)** What burdens / benefits do you believe will result from the redefinition of an adequate mechanism as proposed in paragraph 1.3?

**Q1(ii)** If you believe that burdens will result, what would be the extra cost per payment?

**Q1(iii)** If you believe that benefits will result, what would they amount to per payment?

Your answers to the two questions above will be understood to offset one another.

**Q1(iv)** Would there be a cost of transition to the new arrangement, if so, please indicate why and what cost you believe this would be? **(£ per contract in the first year of operation)**

**Q1(v)** If you are proposing alternative items for the definition of an adequate mechanism please indicate the burdens, costs etc as requested in Q1(ii) to (iv) for these proposals.

## 2. Removing the requirement to serve a Section 110(2) notice in the Construction Act.

### The issue

- 2.1 The review 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". As a result of this it seems that it is relatively common for payers not to serve the notice and so there is no clear trigger for the start of the payment process.
- 2.2 Although some standard forms of contract impose a sanction on the payer where no payment notice is served, these are an exception from the general approach of the contract writing bodies.
- 2.3 The review also took the view that the problem with the Section is exacerbated by the fact that Section 110(2) introduces the term "due date" into the legislation. This can be misinterpreted as indicating that a legal claim arises because the payment becomes "due" at that specific time. In fact a legal claim to payment arises at the "final date for payment" described in Section 110(1) and relates to the value of the work done under the contract.

### Current legislation

Section 110(2) currently requires that:

*Every construction contract shall provide for the giving of notice by a party not later than five days after the date on which a payment becomes due from him under the contract, or would have become due if-*

- (a) the other party had carried out his obligations under the contract, and*
- (b) no set-off or abatement was permitted by reference to any sum claimed to be due under one or more other contracts,*

*specifying the amount (if any) of the payment made or proposed to be made, and the basis on which that amount was calculated.*

### Proposed way forward

- 2.4 We have accepted the review's assessment that Section 110(2)
- a) contains inconsistencies which can lead to confusion; and
  - b) does not in fact achieve the purpose intended (ie to make clear what payment is due and when).

We therefore propose that the requirement for a notice in Section 110(2) should be removed.

- 2.5 Instead (as the review recommended) we believe the adequate mechanism described in section 1 of this consultation more effectively covers the communication between the parties envisaged by Section 110(2). Under that proposal communications would be linked to the "assessment date".

### **Scheme for Construction Contracts**

- 2.6 We propose that the current requirement for a payment notice in Paragraph 9 of Part II the Scheme should be retained as part of the adequate mechanism. Minor drafting changes may be needed to reflect the removal of the concept of a "due date". Though we consider the prescriptive nature of the payment notice to be unnecessary as a requirement of all contracts, the notice does appear to provide a useful fallback where the contractual mechanism proves inadequate.

### **Alternative proposals**

- 2.7 The review considered and rejected an alternative approach which requires an application process as a sanction for non-compliance with Section 110(2). We propose an application process under section 3 of this consultation paper but it would not provide this default mechanism. We believe the current adjudication process is sufficient for the purpose of addressing the failure of a party to implement the adequate mechanism outlined in paragraph 1.3 of this document.

### **Consultation questions**

- Q2.1** Do you agree that the current requirement for a payment notice under Section 110(2) is ineffective **(Yes / No – please explain)**
- Q2.2** Do you agree that the requirement in Section 110(2) should be removed and that in its place the legislation should clearly define what is meant by "an adequate mechanism for determining what payments become due under the contract, and when"? **(Yes / No – please explain)**
- Q2.3** If we remove this requirement, do you agree that at the same time the concept of a "due date" should be removed from the legislation in favour of, for instance, an "assessment date"? What would be the benefits or problems with this approach?
- Q2.4** Do you consider that it would be sufficient to provide guidance on the current legislation setting out the intended effect of the notice rather than changing the legislation? **(Yes / No)**
- Q2.5** If the requirement for a payment notice in Section 110(2) were to be removed, do you agree that the requirement for a payment notice in Paragraph 9 of Part II of the Scheme for Construction Contracts should be retained as a fallback payment mechanism for cases where the mechanism in the contract proves inadequate? **(Yes / No – please explain)**

- Q2.6** Are there other amendments to the payment framework in the Scheme for Construction Contracts you would wish to suggest if we amend Section 110(2) as proposed?
- Q2.7** Would you support the alternative proposal considered and rejected by the review (the imposition of a sanction for the failure to serve a Section 110(2) notice) and, if so, how could we tackle the issues that arise with this approach?
- Q2.8** Do you have any other proposals for how the issues identified by the review could be addressed? If so, please describe them and the benefits / issues that would arise from your proposed approach.

### **Regulatory impact**

- 2.8** We consider that the requirement to serve a Section 110(2) notice imposes a burden on the parties to the payment process. Since it is ineffective and there is the potential for confusion as to the exact meaning of the notice, this burden is likely to be both significant and unnecessary. To help us assess whether the alternative approaches set out above and any proposed approaches you suggest in your response to this consultation will deliver a fairer payment process and reduce this cost / burden, we would welcome your evidence on the burden imposed by the current legislative approach.
- Q2(i)** If you believe that the requirement for Section 110(2) notices should be dropped would this offset any burden resulting from the proposed change to Section 110(1) (**Yes / No**)
- Q2(ii)** What would you estimate to be the financial cost of serving a Section 110(2) notice? (**£ per payment**)
- Q2(iii)** How frequently do you believe Section 110(2) notices are served under construction contracts:
- a)** for 95 – 100% of payments.
  - b)** for 75 – 95% of payments.
  - c)** for 50 – 75% of payments.
  - d)** for 25 – 50% of payments.
  - e)** for 5 – 25% of payments.
  - f)** for 0 – 5% of payments.
- Q2(iv)** How often do you believe a payment dispute arises in part due to a payer's failure to serve payment notice under Section 110(2) of the Construction Act and / or the misunderstanding that there is a legal entitlement to payment of the amount in the notice if it is served?
- a)** as a result more than one in 10 failures to serve a payment notice;
  - b)** as a result of between one in 10 and one in 100 failures;
  - c)** as a result of fewer than one in 100 failures to serve a payment notice;

### 3. Providing an application for payment in the legislation

#### The issue

- 3.1. Many contracts which work well contain terms on an application for payment. The review considered whether the right for the payee to make an application for payment should exist in the legislation or whether the current approach, which leaves the application solely to the terms of the contract, was more appropriate. There is no simple answer.
- 3.2 A large number of questions arise as to how an application might be included in the legislation including:
- whether the application should be available for a payee to submit as of right, or as a requirement of the contract;
  - when the application could be made;
  - what conditions there should be as to the circumstances in which an application should be made;
  - what should constitute a valid application;
  - what are the payers' opportunities to respond to the application and what effect do these have (eg altering timing or amount of payment from that in the contractual payment mechanism);
  - what amount within the application, if any, can the payee become legally entitled to (all / part / none);
  - when any legal claim to an amount should arise; and,
  - how this process relates to the other features of an adequate mechanism.

#### Proposed way forward

- 3.3 We believe the proposed wording of Section 110(1) should go a long way towards ensuring that issues of this sort are discussed and provisions agreed as part of the contract. It is open to the parties to decide to include any or all of the elements set out in paragraph 3.2 in their contract as appropriate to the work being undertaken.
- 3.4 Given the absence of a simple answer to the question of the right of application that is appropriate in all possible circumstances, we would only propose addressing this issue through an amendment to the legislation if there was a broad consensus. This would need to cover both the principle and the content of such a provision. We would also need to present clear evidence that this provision would not generate a burden on business or an increased number of disputes.

- 3.5 We would therefore welcome views on whether the legislation should provide for an application for payees along the following lines:
- The payee has a right to issue the application for payment at any time if they wish.
  - The application should state what the payee believes to be the date for payment, and the amount due, under the contract (less any set-offs which the payer has notified him of by issuing a withholding notice under Section 111 of the Construction Act).
  - The payer would remain responsible under the law only to pay the amount that is properly due, by the final date for payment, under the contract (less any amount that is properly set-off).
  - It is not necessary for an application for payment to have been made by the payee prior to referring a dispute over payment to adjudication, arbitration or litigation (in other words, we would not want to build any delay into the access to adjudication).
  - Should the payer pay the amount applied for, and it emerge that the payment is more than the amount properly due under the contract, less any amounts properly set-off, this could be rectified in any future stage payment, through adjudication or legal action.

3.6 The proposal could act as a mechanism to ensure that the payee can initiate the communication process on payment issues either before the assessment date or afterwards if no communication takes place. It could also enable a payee to respond once the payment has been communicated through the adequate mechanism, should he not agree with the payment proposed to be made. Although he could of course go to adjudication etc in this circumstance.

### **Scheme for Construction Contracts**

3.7 We do not foresee the need for any consequential amendment to the Scheme.

### **Consultation questions**

- Q3.1** Do you believe that an application should be provided in the legislation for a payee to submit...
- a) as of right (as in our suggested proposal)?
  - b) as a requirement of a contract that complies with the Construction Act?
  - c) where the contract does not contain any provision for an application?
  - d) other (please specify)? or,
  - e) not at-all.

Please indicate the benefits / problems with these options and why you believe your recommendation to be the best option.

**Q3.2** If we pursued the proposed amendment, do you believe there should be any restriction on the timing of a valid application for payment? If so, please say why and what the burden or benefit of this restriction would be.

**Q3.3** What conditions do you believe should be set as to the circumstances in which a valid application should be made?

- a) No conditions should be set (as in the our suggested proposal).
- b) An application should only be made where the payee believes the contractual payment mechanism has failed to operate correctly.
- c) Other (please specify).

What would be the advantages / disadvantages of your preferred option?

**Q3.4** What information do you believe should be contained within an application for it to be valid?

- a) The amount the payee expects to be paid (the amount due under the contract less any amounts that have been properly set-off by issuing a withholding notice under Section 111 of the Construction Act)?  
**(Yes / No)**
- b) The final date for payment when the applicant understands he should receive / have received the payment applied for? **(Yes / No)**
- c) Other – please specify.

**Q3.5** Do you believe the payer should have...

- a) no right of response to the application?
- b) a general right of response to the application?
- c) a specified right of response with requirements as to content and / or timing of the response (please specify)?
- d) Other – please specify?

**Q3.6** Do you believe that the amount applied for should become payable by the specified final date for payment under the legislation ?

- a) No (as in our proposal)?
- b) Yes – but only if the payer has not responded to the application?
- c) Yes – though only to the extent considered appropriate by an adjudicator, arbitrator or court in certain circumstances?
- d) Yes – but only to the extent agreed by the payer (leaving adjudication etc to settle any disputes)?
- e) Yes – under the legislation as an automatic requirement in certain circumstances? If so, which circumstances?
- f) Yes – other (please specify)?

- Q3.7** Where the amount in the application becomes payable, what opportunities do you believe the payer should have to respond?
- a) Should the payer be allowed to issue a withholding notice under Section 111 of the Construction Act? **(Yes / No)**
  - b) Should the payer be allowed to respond with an alternative amount or required to pay the full sum in the application? **(Yes / No)**
  - c) Should the payer be allowed to dispute the payment amount or date in the application? **(Yes / No)**
  - d) Is there a further option we have not set out? If so, please provide details and indicates the benefits / burdens it would impose.

### **Regulatory impact**

3.8 We would welcome views on whether the proposal would impose a burden on business and whether, by setting out the detailed operation of the mechanism in the legislation, this burden would be offset.

3.9 Our intention is that the proposal should have the effect of reducing disputes and referrals to adjudication, arbitration or litigation. Whilst it might be argued that it would trigger the commencement of dispute procedures we believe that in many cases these procedures would inevitably have been triggered at some point. The proposal could therefore serve to clarify the information available to inform a referral or response. Furthermore, it could be argued that some disputes would be avoided by enabling the payee to point out to the payer that there is a problem and enable the issue to be addressed through the terms of the contract without recourse to a disputes procedure.

- Q3(i)** What do you believe is likely to be the administrative cost of...
- a) ...issuing an application under the legislation as described in section 3.5, and,
  - b) ...receiving such an application? How would this compare to current costs?

**(Please specify your answer in £ per payment)**

- Q3(ii)** Which parts of the proposed application process would lead to a burden (if any) and why? **(please specify your answer in £ per payment)**

- Q3(iii)** Which one of the following do you think would be the most likely way in which the right of application proposed in section 3.5 would be used?
- a)** In response to the large majority of payment transactions under the existing legislation or the proposed "adequate mechanism".
  - b)** When the payee is unhappy with the amount proposed to be paid.
  - c)** When the payee believes the contractual payment mechanism has failed and an amount should have been ascertained.
  - d)** At the conclusion of the withholding period under Section 111 of the Construction Act when the payee is unhappy with the amount proposed to be withheld and / or paid.
  - e)** When the payee believes he has not received the payment due by the final date for payment under the contract.
  - f)** Other – please specify.
- Q3(iv)** Given your answer above, how frequently do you believe the right of application would be exercised under the proposal in section 3.5?
- a)** For 95 – 100% of payments.
  - b)** For 75 – 95% of payments.
  - c)** For 50 – 75% of payments.
  - d)** For 25 – 50% of payments.
  - e)** For 5 – 25% of payments.
  - f)** For 0 – 5% of payments.
- Q3(v)** Do you believe the number and complexity of disputes in the construction industry would be likely to increase or decrease by issuing an application under the proposal in section 3.5? Please indicate your reasons.

## 4. Redefining the content of withholding notices under Section 111

### The issue

- 4.1 Withholding notices are legally required only when making a "set-off" from the amount due. There is no strict legal requirement for the paying party to issue a withholding notice when revising the amount considered to be due under the contract. In practice withholding notices are generally used for this purpose as an effective means of communication.
- 4.2 Currently the legislation makes no requirement that the withholding notice should give details of the amount remaining to be paid after the amount in the notice is withheld. The review reported cases where people didn't know what this amount was despite having received the notice.
- 4.3 The review also emphasised the need to provide sufficient detail in the withholding notice to ensure that problems that have lead to the need to withhold payment can be resolved.
- 4.4 The proposed removal of Section 110(2) will require some revision of Section 111(1). With this amendment there will then be only one payer notice so this should further simplify current arrangements.

### Current legislation

Section 111 reads:

*(1) A party to a construction contract may not withhold payment after the final date for payment of a sum due under the contract unless he has given an effective notice of intention to withhold payment.*

*The notice mentioned in section 110(2) may suffice as a notice of intention to withhold payment if it complies with the requirements of this section.*

*(2) To be effective such a notice must specify-*

- (a) the amount proposed to be withheld and the ground for withholding payment, or*
- (b) if there is more than one ground, each ground and the amount attributable to it,*

*and must be given not later than the prescribed period before the final date for payment.*

*(3) The parties are free to agree what that prescribed period is to be.*

*In the absence of such agreement, the period shall be that provided by the Scheme for Construction Contracts.*

*(4) Where an effective notice of intention to withhold payment is given, but on the matter being referred to adjudication it is decided that the whole or part of the amount should be paid, the decision shall be construed as requiring payment not later than-*

*(a) seven days from the date of the decision, or*

*(b) the date which apart from the notice would have been the final date for payment,*

*whichever is the later.*

### **Proposed way forward**

4.5 We wish to encourage open communication by placing the emphasis of the legislation on agreement and reduce rather than increase disputes. We therefore propose that the legislation should require all withholding notices to state the remaining amount that the payer intends to pay after withholding the amount notified. This very limited amendment, along with the removal of the final sentence of Section 111(1) should help to improve the clarity of this Section.

4.6 We support the position of the courts that issuing a withholding notice should not be a precondition to the payer revising the amount considered to be due under the contract, though it should be necessary to set-off any amounts from the amount due. However the use of withholding notices should be encouraged as good practice. We believe it to be a matter for guidance to encourage good practice in this area.

### **Alternative proposal**

4.7 We do not propose to take action on the question of giving sufficient detail when giving grounds for withholding payment. The review was not able to recommend any objective tests of what this might be. We feel that the absence of these tests will result in large numbers of unnecessary disputes about what constitutes sufficient detail. The current drafting appears to be adequate as a means of notifying the payee – the main purpose of Section 111.

### **Scheme for Construction Contracts**

4.8 There is no need for a parallel amendment to the Scheme for Construction Contracts since the detail of the contents of the withholding notice is only included in primary legislation.

### **Consultation questions**

**Q4.1** Do you agree that the legislation should be changed to require that a Section 111 notice provides details of the final amount to be paid?  
**(Yes / No)**

**Q4.2** Do you agree that following the removal of Section 110(2) and the inclusion of a definition of an adequate mechanism in Section 110(1), Section 111 should include a requirement to state the amount the paying party intends to pay as well as the amount(s) to be withheld? **(Yes / No)**

**Q4.3** Do you agree that it would not be appropriate to amend the legislation to include a description of what would represent sufficient detail when giving grounds for withholding payment in a Section 111 notice? **(Yes / No)**

Please explain your answers to the above questions.

**Q4.4** What do you believe might represent an objective test of sufficient detail if the legislation were to include such a test?

### **Regulatory impact**

4.9 We believe that the proposal to require the withholding notice to state the amount that remains to be paid should add little or no burden of administration to the process. Though they are not required by law, withholding notices are commonly issued for revisions of the amount due, as contracting parties recognise the value of the withholding process.

**Q4(i)** Do you agree with our assessment that there is only a negligible cost to the payer of stating the payment he now intends to make when issuing a withholding notice? **(Yes / No)**

**Q4(ii)** If you have answered "No" above, what additional cost do you believe might be involved for the payer to include the amount intended to be paid in a withholding notice? **(£ per payment)**

**Q4(iii)** How often do you believe a payment dispute arises as a result of the failure of the withholding notice to state the amount intended to be paid after withholding?

- a) As a result more than one in 10 failures to state the amount intended to be paid.
- b) As a result of between one in 10 and one in 100 failures to state the amount intended to be paid.
- c) As a result of fewer than one in 100 failures to state the amount intended to be paid.

**Q4(iv)** How often do you believe a payment dispute arises as a result of a payer's failure to serve a withholding notice when revising the amount he understands to be due under the contract (by an abatement)?

- a) As a result more than one in 10 failures to issue a withholding notice for an abatement.
- b) As a result of between one in 10 and one in 100 failures to issue a withholding notice for an abatement.
- c) As a result of fewer than one in 100 failures to issue a withholding notice for an abatement.

## 5. Restricting the use of pay-when-certified clauses

### The issue

- 5.1 The review accepted that in many contracts certification by a supervising officer of payments is a normal and effective method of confirming sums due under the main contract. However, the review raised some concerns about lack of clarity when a sub-contract uses the certification process under the main contract as part of its payment mechanism. The certificate could be used to determine:
- the timing of the payment under the subcontract, as in the "assessment date" (a "pay-when-certified" clause); or,
  - the size of the payment, as in the amount due under the subcontract (a "pay-what-certified" clause).
- 5.2 These concerns centred on the potential for such clauses to lead to a lack of clarity in the process. There are a number of considerations including:
- A certification process under the main contract is largely invisible to the subcontractor, potentially making it difficult to identify the grounds for the failure or refusal to issue a certificate.
  - Where a certificate is issued an element of work priced by the certificate may cover works where the work delivered by an individual subcontractor forms only one part. As a result, the certificate might not indicate the state of completion of that subcontractor's work, or the payment that is due for it. It may only be possible to identify that any individual part of the work is due for any payment at all under the certificate when the whole element is certified as complete.
  - Also, while the elements within the certificate will be priced under the pricing framework in the main contract, an individual subcontractor's work may be priced under an entirely different framework in the subcontract.
- 5.3 We are concerned by the possibility that pay-when-certified clauses could be used in situations where the certification process used to make payments under the main contract could be unsuitable for payments under an individual subcontract.
- 5.4 Having said that, we are aware that there are situations where the use of pay-when-certified clauses in subcontracts is not problematic:
- Management contracting arrangements – where almost all the key subcontractors are employed under separate contracts direct with the client.
  - Nominated subcontractor arrangements – where a specific subcontractor is nominated by the client.

In both these arrangements it is possible to ascertain from a certificate whether a payment is due for an individual item of work and what that payment should be.

### **Proposed way forward**

- 5.5 Taking account of the above, we therefore propose to amend the Construction Act so that where the adequate mechanism links:
- a) the timing of payment for work under the contract to the timing of the certification of the work under another contract (a "pay-when-certified" clause); or,
  - b) the amount to be paid for the work under the contract to an amount certified for payment for the work under another contract (a "pay-what-certified" clause);

...this should only be possible where the contract:

- identifies the element of the works in the certificate, of which the subcontract work forms a part ;
- identifies when certificates will become due for the element in question;
- requires that a copy of the certificate is passed to the subcontractor within five days of the assessment date;

..and (in case b)...

- provides that the work will be priced as an individual element in the certificate even where the certificate covers a wider range of work; and,
- describes how the payment due under the subcontract will be ascertained based upon the figure given in the certificate.

### **Scheme for Construction Contracts**

- 5.6 We propose that the payment mechanism in Part II of the Scheme for Construction Contracts should apply in place of the pay-when-certified arrangement if it becomes clear that it does not constitute an adequate mechanism as described in paragraph 5.5. We do not believe that this will require any amendment to the Scheme.

### **Alternative proposals**

- 5.7 The review considered an alternative proposal to address the problems that can be caused by the inappropriate use of pay-when-certified clauses. This was to amend the legislation to make clear that the "adequate mechanism for determining what payments become due under the contract, and when" must provide specific dates as to when payments become due, rather than stating the events that would trigger what payments had become due (such as the receipt of a certificate). We believe this proposal imposes a considerable regulatory burden and could itself be inappropriate (if work is delayed for example).

- 5.8 A proposal to require an absolute ban on all conditional payment provisions (other than under management contracting or nominated subcontractor arrangements) through Section 113 of the Construction Act was also put to the review. On the basis that pay-when-certified clauses can have a helpful and proper role to play to promote cash flow in certain payment mechanisms we do not believe this would deliver improved payment practices.
- 5.9 We could opt not to amend the legislation. Respondents to the consultation may feel that guidance is sufficient to raise the awareness of subcontractors to the potential difficulties associated with pay-when-certified clauses. It would then be for the parties to negotiate how a pay-when-certified clause should feature in an adequate payment mechanism.

### **Consultation questions**

- Q5.1** Do you agree that pay-when-certified clauses have a valuable role to play in the operation of some types of contract? Do you agree that their use should be limited to particular circumstances? What would these circumstances be? What are the benefits / burdens of your approach?
- Q5.2** Do you agree that there may be circumstances in which it is appropriate for a main contractor to ascertain the amount to be paid for work under a subcontract on the basis of certificate covering that work under the main contract (a "pay-what-certified" clause)? **(Yes / No)**
- Q5.3** Do you agree that there may be circumstances in which it is appropriate for payments to be triggered by the receipt of a certificate reflecting the work done rather than on specific dates in the contract?  
**(Yes / No – please give reasons)**
- Q5.4** Do you agree that where a pay-when-certified arrangement is provided in a contract...
- a)** ...the contract should identify the element of the works in the certificate, of which the subcontract work forms a part and when the certificate will become due under the main contract for the element in question? **(Yes / No)**
  - b)** ...the contract should require that a copy of the certificate is passed to the subcontractor within five days of the ascertainment date?  
**(Yes / No)**
  - c)** ...other – please specify.

- Q5.5** Furthermore, do you agree that where the amount to be paid under the subcontract is to be determined by the certificate under the main contract (a "pay-what-certified" arrangement), the subcontract should...
- a) ...provide that the work will be priced individually in the certificate as part of the package of work it covers? **(Yes / No)**
  - b) ...describe how the payment due under the subcontract will be ascertained based upon the price in the certificate? **(Yes / No)**
  - c) ...other – please specify.

**Q5.6** Do you believe that the proposal is appropriate for "management contracting" arrangements where they involve pay-when-certified clauses? **(Yes / No – please give reasons)**

**Q5.7** Do you believe that the proposal is appropriate for contracts with "nominated subcontractors" where they involve pay-when-certified clauses? **(Yes / No – please give reasons)**

**Q5.8** Do you believe the contractual payment mechanism should make any further minimum requirements on the determination of payment under pay-when-certified clauses? If so, what are these?

**Please comment on or explain to any of the answers you have given to the above questions.**

**Q5.9** Do you support any of the alternative approaches? If so, please say why?

**Q5.10** Do you agree that the current payment mechanism in the Scheme (with the limited changes proposed in earlier chapters) would constitute a suitable fall back payment mechanism if a "pay-when-certified" or "pay-what-certified" clause were to be rendered void? **(Yes / No – please explain)**

### **Regulatory Impact**

5.10 The proposed way forward permits the parties to decide whether to use pay-when-certified clauses or pay-what- certified clauses where appropriate. But it requires inclusion of specific details where they do so in order to ensure clarity. It could be argued that this simply formalises work which would need to be done in any case in agreeing a contract where such clauses are used, rather than generating a new burden on business. We would welcome views on this.

**Q5(i)** What proportion of subcontracts do you believe contain pay-when-certified clauses for one or more payment stages?

- a) For 95 – 100% of subcontracts.
- b) For 75 – 95% of subcontracts.
- c) For 50 – 75% of subcontracts.
- d) For 25 – 50% of subcontracts.
- e) For 5 – 25% of subcontracts.
- f) For 0 – 5% of subcontracts.

- Q5(ii)** What proportion of contracts do you believe contain "pay-what-certified" clauses for one or more payment stages?  
**(answer using list (a) – (g) in the question above)**
- Q5(iii)** How often do you believe a payment dispute arises in part due to the inclusion of a "pay-when certified" or pay-what-certified clause?  
 a) As a result more than one in 10 clauses in contracts.  
 b) As a result of between one in 10 and one in 100 clauses in contracts.  
 c) As a result of fewer than one in 100 clauses in contacts.
- Q5(iv)** Do you agree that the proposed requirement to provide information on the certification process during the contract agreement and assessment stages when using a pay-when-certified clause places a very limited burden on the contracting process? **(Yes / No – please state in £s per payment)**
- Q5(v)** What do you believe would be the cost of transition to the arrangement under the proposal for "pay-when-certified" clauses?  
**(please specify in £s per contract during the first year of operation)**
- Q5(vi)** Do you believe that there will be a change in the proportion of contracts containing "pay-what-certified" clauses for one or more payment stages under the proposed way forward **(answer using list (a) – (c) in question Q5(i) above – please explain).**
- Q5(vii)** What would be the cost of revising the certification process to enable the value of works to be identified within a broader range of works covered by a certificate? How would this cost compare with the current situation where a sub-contractor seeks payment in this situation? What do you believe is the likely cost of transition to the arrangement under the proposal for "pay-what-certified" clauses? **(please state in £s per contract affected in the first year of operation)**
- Q5(viii)** Do you believe there is likely to be a reduction in the use of "pay-what-certified" clauses as a result of the proposed amendment to the Construction Act? If so, please say why and what the cost would be in £s per payment
- Q5(ix)** Do you believe there is likely to be any ongoing cost to main contractors who have to alter their practices in order to use "pay-what-certified" clauses because of the proposed amendment to the Construction Act? **(Yes – please specify in £s per contract / No)**

# Chapter II – Other payment proposals

*Improving the ability of the parties to a construction contract to manage cash flow and complete work on the project in the event that problems arise for reasons outside of their control such as defaulted payments, or disputes or insolvencies elsewhere in the supply chain.*

## 6. Introducing a right to reimbursement for the costs of suspension and remobilisation and to allow additional time for remobilisation under Section 112 of the Construction Act

### The issue

- 6.1 The legislation currently provides a statutory right to suspend work under a construction contract in cases of non-payment and sets out how this right may be exercised. Section 112(4) also provides that there should be a readjustment to the contract to compensate for the time lost during a period of suspension.
- 6.2 The review considered that the current position did not go far enough with the result that, in some circumstances, contractors are unable to make effective use of the right to suspend. This is because the cost of suspending performance as well as the cost of remobilisation presents a disproportionate cost which acts as a significant disincentive. Furthermore, the legislation currently stipulates that the right of suspension ceases when the party in default pays the full amount due. The review identified instances where it was either impracticable or inappropriate for a contractor to remobilise immediately – for instance, for reasons of public health and safety.

### Current legislation

Section 112 reads:

*(1) Where a sum due under a construction contract is not paid in full by the final date for payment and no effective notice to withhold payment has been given, the person to whom the sum is due has the right (without prejudice to any other right or remedy) to suspend performance of his obligations under the contract to the party by whom the payment ought to have been made ("the party in default").*

*(2) The right may not be exercised without first giving to the party in default at least seven days' notice of the intention to suspend performance, stating the ground or grounds on which it intended to suspend performance.*

*(3) The right to suspend performance ceases when the party in default makes payment in full of the amount due.*

*(4) Any period during which performance is suspended in pursuance of the right conferred by this section shall be disregarded in computing for the purposes of any contractual time limit the time taken, by the party exercising the right or by a third party, to complete any work directly or indirectly affected by the exercise of the right.*

*Where the contractual time limit is set by reference to a date rather than a period, the date shall be adjusted accordingly.*

### **Proposed way forward**

- 6.3 The right of suspension is intended as a means of cash flow management for suppliers rather than a penalty. We agree that the legislation as it stands is not fully effective. It is important, however, that nothing in any amendment compromises the ability of a payer to reject a claim for the costs of suspension and remobilisation where a suspension is unjustified.
- 6.4 We agree with the review recommendation that the statutory right to suspend performance under the contract should be supplemented with a right to reclaim the reasonable costs of suspension and remobilisation. We also agree that an appropriate timescale should be provided for remobilisation once the payment in default is finally made.
- 6.5 However, any changes to the legislation must not create a significant burden on industry or further grounds for dispute – over what might constitute a reasonable cost for remobilisation for instance. Parties to a contract ought reasonably to be able to agree, in their particular circumstances, what constitutes a reasonable cost for suspension and remobilisation and what an appropriate delay might be. Where a contract is silent, some form of backstop is necessary.

### **Scheme for Construction Contracts**

- 6.6 The proposal that (where the contract omits to set out what constitutes the reasonable costs of suspension and remobilisation, and an appropriate delay) a backstop is required will need to be reflected in the Scheme. We propose that the reasonable costs of suspension and remobilisation should not exceed 5% of the value of the payment in default. We further propose that an appropriate delay in remobilisation ought not to exceed seven days.

## Consultation questions

- Q6.1** Do you agree that it is necessary to supplement the right to suspend performance under the contract? If so, please explain the impact of the current deficiencies in the legislation (in terms of cost, time, disputes etc.).
- Q6.2** Do you believe that an enhanced right of suspension should include...
- a) ...the right to recover the reasonable costs of suspension?  
**(Yes / No – please explain)**
  - b) ...the right to recover the reasonable costs of remobilisation?  
**(Yes / No – please explain)**
  - c) ...the right to require an appropriate delay in remobilisation?  
**(Yes / No – please explain)**
  - d) ...other – please specify.
- Q6.3** Do you agree that the issue of what constitutes
- a) the reasonable costs of suspension;
  - b) the reasonable costs of remobilisation;
  - c) an adequate delay in remobilisation
- is best dealt with as a matter of contract?  
**(Answer Yes / No for each of (a) – (c))**
- Q6.4** Do you believe that, in the absence of any contractual agreement, there should be a fallback position in the Scheme for Construction Contracts?  
**(Yes / No)**
- Q6.5** If there is a fallback, do you agree that it should:
- a) set the reasonable maximum cost of suspension and remobilisation at 5% of the value of the payment in default? If not, please indicate in what circumstances you believe this figure could be inappropriate and what alternative figure you believe would be more appropriate.
  - b) set the appropriate maximum delay in remobilisation at seven days? If not, please indicate in what circumstances you believe this figure could be inappropriate and what alternative figure you believe would be more appropriate.

## **Regulatory impact**

- Q6(i)** How frequently in cases of defaulted payment do you believe the right to suspend performance under the contract is exercised:
- a)** in more than one in 10 instances of defaulted payment;
  - b)** in between one in 10 and one in 100 instances of defaulted payments;
  - c)** in fewer than one in 100 instances of defaulted payment.
- Q6(ii)** Under the proposed change in the law, how frequently do you believe that the right of suspension will be exercised:
- a)** in more than one in 10 instances of defaulted payment;
  - b)** in between one in 10 and one in 100 instances of defaulted payments
  - c)** in fewer than one in 100 instances of defaulted payment;
- Q6(iii)** What do you believe are the typical costs of suspension of performance? (£)
- Q6(iv)** What do you believe are the typical costs of remobilisation? (£)
- Q6(v)** How would these costs change if we introduced the fallback outlined above in paragraph 6.6?
- Q6(vi)** Given your answers above, what do you believe would be the typical minimum defaulted payment for which a contractor would consider suspending performance...
- a)** ...under the current law? (£)
  - b)** ...under the DTI's proposed change in the law? (£)

## 7. Making contractual provisions on cross contract set-off ineffective

### The issue

- 7.1 Cross contract set-off is the practice whereby money being withheld on one contract can be set off against another contract relating to an entirely different project but involving the same parties. The review was concerned that this practice does not operate in the best interests of the industry and its clients. The review believed there could be little general benefit in allowing a dispute on a problematic project to have a negative impact on the delivery of a totally separate project that was otherwise running well. The review therefore agreed that cross contract set-off should be legislated against – as Sir Michael Latham had recommended in "Constructing the Team".
- 7.2 The review agreed that the prohibition should not extend to the common law right of equitable set-off. The review also wished to retain a right to set-off across closely related contracts where it was suggested it was not clear whether a right of equitable set-off would arise – for instance under a framework agreement.

### Proposed way forward

- 7.3 We are concerned to remove contractual practices which create unfairness and do not deliver general benefit to the industry and its clients. We wish to encourage the effective management of risk within the confines of individual projects wherever this is appropriate.
- 7.4 We believe there is merit in providing that the use of cross contract set-off should be limited to equitable set-off. We believe the current test for equitable set-off – where "a close relationship exists between the dealings and transactions which gave rise to the respective claims" – is sufficient to meet the needs of the construction industry.
- 7.5 We therefore propose to include in the Construction Act a provision making clauses on cross contract set-off unenforceable. We intend that the common law right of equitable set-off should remain available. As a right in law this would not be covered by a prohibition of contractual terms on cross contract set-off.

## **Scheme for Construction Contracts**

- 7.6 The proposal would not require any amendments to be made to the Scheme for Construction Contracts.

### **Alternative proposals**

- 7.7 There may be instances where the ability to agree to a cross contract set-off going beyond the common law right represents the most effective way for all involved to resolve a difficulty on another project or contract. In these circumstances an outright ban on the use of cross contract set-off, other than in the limited circumstances described in the proposal above, could actually work against the twin objectives of improving cash flow in the industry and reducing litigation. We would therefore welcome views on whether it would be beneficial to include in the legislation the ability for the parties to the contract to agree as part of the contract other criteria which set out the basis on which set-off may be permitted.

### **Consultation questions**

- Q7.1** Do you agree that the use of cross contract set-off should be limited? Please explain the costs / benefits to the industry of your recommended approach.
- Q7.2** Do you believe that the common law definition of "equitable set-off" ("a close relationship exists between the dealings and transactions which gave rise to the respective claims") provides sufficient flexibility to meet the reasonable requirements of the construction industry? **(Yes / No)**
- Q7.3** Do you believe that cross contract set-off should generally be permitted where the work is part of a series of projects under framework or similar agreements? **(Yes / No)**
- Q7.4** If yes, please explain which contracts / commercial arrangements would fall into this category which you believe would not be covered by the right of equitable set-off.
- Q7.5** What safeguards or contractual terms would be needed to ensure that such agreements were used fairly?
- Q7.6** Do you believe that allowing contractual provisions on cross contract set-off where the contract allows for the prior agreement of the set-off represents the best way forward? **(Yes / No)**
- Q7.7** If yes, please explain the circumstances in which you think this would be beneficial and the costs / benefits of the contractual freedom you propose.

## **Regulatory impact**

- Q7(i)** What is the cost to the industry of the use of set-off clauses? What would be the impact on these costs of the different options discussed in this section (limiting set-off to the common law definition, permitting set-off in defined contractual arrangements, allowing pre-agreement to specific set-off clauses)?
- Q7(ii)** How often do you believe contracts contain cross-contract set-off clauses:
- a)** in 95 – 100% of cases.
  - b)** in 75 – 95% of cases.
  - c)** in 50 – 75% of cases.
  - d)** in 25 – 50% of cases.
  - e)** in 5 – 25% of cases.
  - f)** in 0 – 5% of cases.
- Q7(iii)** How often do you believe set-off clauses are invoked?
- a)** In more than one in 10 cases where the clause is contained in the contract.
  - b)** In between one in 10 and one in 100 cases where the clause is contained in the contract.
  - c)** In fewer than one in 100 cases where the clause is contained in the contract.
- Q7(iv)** Do you believe that invoking a cross contract set-off clause in a contract is likely to...
- a)** ...cause or escalate a dispute between contracting parties?
  - b)** ...shift a dispute from one project to another project without resolving it?
  - c)** ... help to prevent or resolve a dispute between contracting parties?

## 8. Making "pay-when-paid" clauses ineffective in cases of "upstream" insolvency proceedings

### The issue

- 8.1 Whenever an insolvency occurs, a significant burden can be imposed on other parties engaged in projects with the party that is subject to insolvency proceedings. We are concerned that the burden is managed to reduce both the risk to the effective delivery of the project and the threat to the viability of individual businesses in the supply chain.
- 8.2 Section 113 (1) of the Construction Act makes "pay-when-paid" clauses ineffective other than when they are invoked in cases of an "upstream" party being subject to insolvency proceedings. In those circumstances a payment can be withheld on the basis that the payment under contract is dependent upon payment by the insolvent party through a "pay-when-paid" clause in the contract. No finance is then available for the payment to be made until after the assets of the insolvent firm have been administered and a payment has been made to the party invoking the "pay-when-paid" clause. In instances where "pay-when-paid" clauses are invoked, this can have the effect of freezing cash flow from the point of the insolvency down throughout the entire supply chain.
- 8.3 The review agreed that the ability to manage the risk of insolvency was relatively limited wherever a contracting party sat in a supply chain. However, it was unable to agree whether that risk was best managed by preserving the status quo or by removing the exception for "upstream" insolvency proceedings from the prohibition of "pay-when-paid" provisions in Section 113 of the Construction Act.

### Current legislation

Section 113(1) states:

*A provision making payment under a construction contract conditional on the payer receiving payment from a third person is ineffective, unless that third person, or any other person payment by whom under the contract (directly or indirectly) a condition of payment by that third person, is insolvent.*

### **Proposed way forward**

- 8.4 The review was unable to agree an approach that would, for all parties in the supply chain, deliver a fairer outcome than the current legislation. The review was presented no clear evidence that the removal of the current exception would achieve this. In these circumstances and in the absence of evidence to support a change in the law, there can be no option other than to maintain the status quo.

### **Scheme for Construction Contracts**

- 8.5 There would be no requirement for an amendment to the Scheme for Construction Contracts in relation to this issue.

### **Alternative proposals**

- 8.6 We would like to use this consultation to better understand what benefits / issues might arise for the industry as a whole from the prohibition of the use of "pay-when-paid" clauses in cases of insolvency.
- 8.7 Whilst the review accepted that the ability of anyone to manage the risk of a contracting party becoming subject to insolvency proceedings was limited, those who were in a direct contractual relationship with the party in question were better placed. The review also considered, but was unable to quantify, the possible change in the cost of insuring against the risk of non-payment due to insolvency if "pay-when-paid" clauses were made ineffective.

### **Consultation questions**

- Q8.1** Do you believe it is beneficial to the industry to retain the ability to invoke "pay-when-paid" clauses in cases of "upstream" insolvency proceedings?
- Q8.2** If you believe these provisions should be prohibited, please explain the costs / benefits to the industry in comparison to the current position. Please explain the impacts on cash flow, risk, etc, within the supply chain of your proposed approach.
- Q8.3** Alternatively, are you able to identify another way forward? **(please explain)**

**Q8.4** If yes, please indicate how it would change the impact of insolvency on the supply chain, the benefits to the industry and delivery of projects compared to the present legislation.

**Q8.5** What would you estimate to be the current cost of insurance to cover non-payment due to upstream insolvency? How often are companies covered by such policies? How might this cost change if the current exclusion from the prohibition of "pay-when-paid" clauses were removed?

### **Regulatory impact**

**Q8(i)** Do you believe that the removal of the ability to invoke "pay-when-paid" clauses in the case of upstream insolvency proceedings would result in fewer insolvencies elsewhere in the supply chain? If so, please indicate the cost / benefits to the industry, and to individual elements of the supply chain / clients of this change.

**Q8(ii)** Alternatively, do you believe that the overall cost of insolvency to the supply chain would stay the same regardless of which option was chosen from those set out above?

**Q8(iii)** How frequently do you believe "pay-when-paid" clauses are included in contracts?

- a) In 95 – 100% of contracts.
- b) In 75 – 95% of contracts.
- c) In 50 – 75% of contracts.
- d) In 25 – 50% of contracts.
- e) In 5 – 25% of contracts.
- f) In 0 – 5% of contracts.

**Q8(iv)** How frequently do you believe upstream insolvencies arise under construction contracts? **(answer (a) – (f) in the list provided above)**

**Q8(v)** How frequently do you believe "pay-when-paid" clauses are invoked where they are included in construction contracts where an upstream insolvency occurs?

- a) More than half the time?
- b) About half the time?
- c) Less than half the time?

What is the impact on companies and clients of this action?

## 9. Allowing stage payments under the Scheme for Construction Contracts to be made for materials in advance of their arrival on site

### The issue

- 9.1 The review considered, but was unable to make a recommendation on, whether the Scheme for Construction Contracts should provide for payment for materials off-site in certain circumstances. Though the Scheme allows for payment for work off-site, at present it is not possible under the payment provisions in the Scheme to seek payment for the materials before they arrive on site. An effect can be that the value of the materials following completion of all the work off-site is payable on arrival, but not before.
- 9.2 Work off-site is increasingly relevant as more components on construction projects are prefabricated to some degree and then brought to site. This means that the value of work off-site and of prefabricated materials is growing as a proportion of the total cost of a project. We believe that no amendment to the Construction Act is needed to enable stage payments for work off-site to be agreed between the parties. Section 109(2) (the right to stage payments) already states that "The parties are free to agree the amounts of the payments and the intervals at which, or circumstances in which, they become due". Currently, payment for work off-site is commonly provided for through contractual terms.
- 9.3 However, it is important that the Scheme remains appropriate to support changing delivery processes within the industry. It is clear that the proportion of project value arising from work off-site will continue to grow with significant benefit to quality and health and safety. We are therefore keen to have views on how we can ensure the legislation adequately supports this changing balance. Any proposal would need to tackle the following issues:
- ensuring there is a mechanism for the parties to identify the value of the materials and the work done and its value;
  - ensuring ownership of the components, etc, passes, upon receipt of payment, to the payer; and,
  - ensuring that payment can be recovered if the work undertaken off-site proves unsatisfactory on installation.

## **Current legislation**

Paragraphs 2(1) – 2(3) of Part II of the Scheme provide that:

*(1) The amount of any payment by way of instalments or stage or periodic payments in respect of a relevant period shall be the difference between the amount determined in accordance with sub-paragraph (2) and the amount determined in accordance with sub-paragraph (3).*

*(2) The aggregate of the following amounts –*

*(a) an amount equal to the value of any work performed in accordance with the relevant construction contract during the period from the commencement of the contract to the end of the relevant period (excluding any amount calculated in accordance with sub-paragraph (b)),*

*(b) where the contract provides for payment for materials, an amount equal to the value of any materials manufactured on site or brought onto site for the purposes of the works during the period from the commencement of the contract to the end of the relevant period, and*

*(c) any other amount or sum which the contract specifies shall be payable during or in respect of the period from the commencement of the contract to the end of the relevant period.*

*(3) The aggregate of any sums which have been paid or are due for payment by way of instalments, stage or periodic payments during the period from the commencement of the contract to the end of the relevant period.*

The relevant wording is underlined. Clearly the parties could make specific provision in the contract under (2)(c).

## **Proposed way forward – Scheme for Construction Contracts**

9.4 We would like to amend Paragraph 2(2) of Part II of the Scheme to allow for stage payments for work off-site in order to:

- improve cash flow down the contract chain;
- make clear the paying party's ownership of all the materials and components residing off-site that have been paid for; and,
- enable a refund to be made.

- 9.5 We therefore propose to provide that in addition to "the value of any materials manufactured on site or brought onto site" the amount payable in Paragraph 2(2) of Part II of the Scheme should include the value of any materials that have been part-assembled specifically for the project which is the subject of the contract and have yet to be brought to site, for which:
- ownership is substantiated as transferring to the payer.
  - access will be provided to the payer, on demand, for inspection or collection.
  - a full refund for the value of the materials and components owned by the payer will be available before they reach site or immediately after with the return of ownership to the payee.
  - a full refund will also be available for any work off-site on these materials and components under Paragraph 2(2)(a) of Part II of the Scheme, after ownership is transferred and before or immediately after the materials and components arrive on site.
  - the refund would be available in cases where the work did not meet the original specification. (This refund would be unlikely to be available in full if the supplier were to enter into insolvency proceedings. However ownership of the materials would have transferred so loss to the payer should not be significant.)

9.6 Clearly, whatever the Scheme provisions include, they cannot be as detailed or tailored as wording agreed between the parties in the contract. They would therefore have to remain at the level of "principle" rather than detail. Where contracts not under the Scheme are involved, reliance will, of course, be placed solely on the contractual provisions.

### **Alternative proposals**

9.7 We would welcome alternative proposals that respondents might suggest which meet the objectives in paragraph 9.4 but which do not unreasonably increase risk for the payer or simply shift risk around in the supply chain.

### **Consultation questions**

**Q9.1** Do you agree in principle that the Scheme for Construction Contracts should make provision for stage payments for materials held off-site and off-site work upon them if this is possible? **(Yes / No – please explain)**

- Q9.2** If so, what conditions do you believe should apply for payment to be required for work off-site under the Scheme? (For each of the questions in this section, please indicate whether you agree the provision is helpful, and whether the provision as outlined would deliver the objectives described above or, if not, please indicate how the proposal could be amended to meet your concerns.)
- a) That ownership for the materials paid for is substantiated as having transferred to the payee?
  - b) That access will be provided to the payer, on demand, for inspection or collection?
  - c) That a full refund for the value of the materials owned by the payer off-site will be available with the return of ownership to the payee?
  - d) That a refund should also be available for any work done on the materials and components under Paragraph 2(2)(a) of Part II of the Scheme, once their ownership has transferred to the payer?
  - e) That this refund should become available in cases where the work did not meet the original specification?

**Q9.3** Do you have any alternative proposals? If so, please specify them and explain how they would meet the objectives outlined above. How do contracts you are aware of currently operate?

#### **Regulatory impact**

9.8 This amendment to the Scheme is only likely to affect the small number of contracts that use the Scheme by agreement or use it as a fallback because they do not contain provisions on stage payments already or do not include an adequate payment mechanism. This proposal will be especially useful where stage payments were agreed under the contract and could now continue if the fallback provisions of the Scheme were invoked. This is still likely to be only a small number of cases. Contracting parties would still be at liberty to agree other terms if they so chose but the Scheme defines a basic fallback position.

- Q9(i)** How often do you believe the payment framework in the Scheme for Construction Contracts is used in projects (either by agreement or as a fallback adequate payment mechanism or fallback framework for stage payments)?
- a) in 95 – 100% of projects;
  - b) in 75 – 95% of projects;
  - c) in 50 – 75% of projects;
  - d) in 25 – 50% of projects;
  - e) in 5 – 25% of projects;
  - f) in 0 – 5% of projects.
- Q9(ii)** How often do you believe projects include work on materials held off-site for delivery to site at a later stage (irrespective of whether stage payments are provided)? **(answer (a) – (f) above)**
- Q9(iii)** On how many of the above do you believe stage payments are agreed for the work off-site?
- a) More than half?
  - b) About half?
  - c) Fewer than half?
- Q9(iv)** How often do you believe the existence of payment provisions for work off-site in the Scheme could assist contractors in negotiating stage payments for work off-site where they cannot at present?
- a) In more than one in 10 of the projects described above;
  - b) In between one in 10 and one in 100 of the projects described above;
  - c) In fewer than one in 100 of the projects described above.
- Q9(v)** Where up-front investment is required for work off-site at present, and there are no stage payments provided for in the contract...
- a) ...how great do you believe the supplier's investment to have been before he receives payment for the work and materials? **(£)**
  - b) ...how many days do you believe would follow the initiation of construction work off-site, on average, before a first payment covering the work and materials becomes due? **(Number of days)**

# Chapter III – Adjudication proposals

*Reducing the disincentives to referring disputes to adjudication where it is suitable. The review suggested these might include avoidance or frustration of the process or outcome, unnecessary legal challenge or unpredictable or excessive costs.*

## **10. Preventing the use of "trustee stakeholder accounts" to suspend adjudicators' awards pending litigation other than when the recipient is involved in insolvency proceedings**

### **The issue**

- 10.1 The review considered the problems created by contractual terms which require the sum awarded by an adjudicator to be held in a "trustee stakeholder account" rather than paid directly to the party receiving the adjudicator's award. This contractual term renders the adjudicator's decision ineffective as a means of restoring cash flow as the payment awarded by the adjudicator is not available to be used. Usually the term does not allow the release of the award from the account by the trustee until the dispute has been finally decided by litigation or arbitration.
- 10.2 It is argued by some that this is consistent with the principle in the Construction Act that "the decision of the adjudicator is binding until the dispute is finally determined by legal proceedings, by arbitration or by agreement". This means that an adjudicator's decision may later be overturned or revised. The review heard concerns that this can cause problems where an award is made to a party subject to, or nearing, insolvency proceedings. In these circumstances, if the adjudicator's decision is subsequently revised through arbitration, or by the courts, it might not be possible to recover the award. A number of judgements in the courts have indicated that an adjudicator's award might not be enforceable if there is "serious doubt as to the ability of the claimant to repay the moneys awarded under an adjudicator's decision".

### **Proposed way forward**

- 10.3 We are concerned that, in most cases, the adjudicator's decision should have immediate effect, as is envisaged by the legislation. The current ability to contractually agree to the use of "trustee stakeholder accounts" appears to work against this. We therefore propose to make unenforceable any contractual provision requiring the payment of an adjudicator's award into a trustee stakeholder account.

10.4 However, where the receiving party is involved in insolvency proceedings and such a clause has been agreed, we propose that the new terms of the Scheme for Construction Contracts should apply, as described below.

### **Scheme for Construction Contracts**

10.5 Under the Scheme, the adjudicator should be allowed to require his award to be paid into a “trustee stakeholder” account if the receiving party is subject to insolvency proceedings. We propose that:

- the adjudicator should act as trustee of the award for up to one month.
- in that time the paying party would be able to apply for arbitration or litigation to finally decide the dispute.
- in this case the adjudicator would continue to act as trustee until the case is finally decided.
- if the paying party does not lodge an application for arbitration or litigation the adjudicator would release the award to the receiving party at the end of the month.
- the adjudicator could release the award to the receiving party earlier, if the paying party agreed.

10.6 Our intention is to prevent parties under the Scheme from needing to go to court to obtain a stay in the adjudicator's decision when it is highly likely this would be granted. At present to apply for a stay, the paying party usually refuses to abide by the adjudicator's decision and seeks a stay if the receiving party takes out enforcement proceedings. The current mechanism seems cumbersome and costly to both parties and somewhat unpredictable. We believe that where the parties have entered into adjudication under their own contractual procedures, it is up to them to decide what role “trustee stakeholder accounts” might have where the receiving party is involved in insolvency proceedings.

### **Alternative proposals**

10.7 We believe the above proposal is the most effective way to prevent the use of “trustee stakeholder accounts” as a means of evading the effects of adjudication. However, we would like to use this consultation to consider some potential alternatives:

- a power for the adjudicator to overrule any contractual provision requiring the payment of his award into a trustee stakeholder account;
- a broader power for the adjudicator to overrule any contractual requirement for any payment at all to be made into a trustee stakeholder account (not simply the adjudication award);
- a broader power for the adjudicator to overrule any contractual requirement at all which has the effect of delaying the effect of his decision.

10.8 It would be possible to leave the granting of stays of adjudicators' decisions solely to the courts without legislative intervention. Since there are costs associated with this process, it would encourage parties to accept and to pay adjudication awards irrespective of the financial position of the recipient. This could, of course, lead to payments being made when there is a high risk that sums will not be recoverable later due to insolvency.

### **Consultation questions**

- Q10.1** Is the current use of trustee stakeholder accounts appropriate? What is the impact on the industry (positive or negative)?
- Q10.2** If you think the current practice is not appropriate, how do you think the legislation should be amended to improve cash flow and the effectiveness of the adjudication process? Should we include:
- a) a provision in the Construction Act to make unenforceable contractual provisions requiring the payment of an award into a "trustee stakeholder account?"
  - b) a power for the adjudicator to overrule any contractual provision requiring the payment of his award into a "trustee stakeholder account?"
  - c) a broader power for the adjudicator to overrule any contractual requirement for payment at all to be made into a "trustee stakeholder account" (not simply the adjudication award)?
  - d) a broader power for the adjudicator to overrule any contractual requirement at all which has the effect of delaying the effect of his decision?
  - e) Other – please specify
- Q10.3** Do you believe that the adjudicator should be allowed to make his award into a "trustee stakeholder account" in cases where the receiving party is subject to insolvency proceedings. If so, should this be possible:
- a) under all adjudications by including a requirement in the Construction Act?
  - b) under all adjudications under the Construction Act as the only means of obtaining a stay in the adjudicator's decision?
  - c) only in adjudications under the Scheme and in cases where the parties have agreed to the use of a "trustee stakeholder account" for adjudicators award (as we have proposed)?
  - d) Other (please explain)?
- Alternatively, do you believe that:
- e) stays in an adjudicator's decision should only be available through the courts?
  - f) stays in adjudicator's decisions should not be available at all?

**Q10.4** If you do believe that the adjudicator should have the ability to place his award into a “trustee stakeholder account,” when should this be permitted or required?

- a) when the receiving party is subject to insolvency proceedings?
- b) other – please specify?

Please give the reason for your recommendation and indicate the change in costs, risks to different members of the supply chain (and its clients) and to delivery of projects that you believe would result.

**Q10.5** If the law were to provide for the payment of adjudicators' awards into trustee accounts when a receiving party appears likely to become the subject of insolvency proceedings, do you believe that on the application of a paying party ...

- a) ... the courts need to fulfil the role of determining whether a receiving party is likely to become subject to insolvency proceedings (as at present)?
- b) ...the adjudicator could equally fulfil the role of determining whether a receiving party is likely to become subject to insolvency proceedings?

We would welcome respondents views on how this mechanism could operate and the risks and costs associated with your proposed solution.

**Q10.6** Should it be agreed that the adjudicator should have the power to place payments in a “trustee stakeholder account,” how do you believe that the proposed trustee stakeholder account should operate?

- a) Do you agree that the adjudicator should act as the trustee?  
**(Yes / No please give reasons)**
- b) How long do you believe the adjudicator should hold the award for before it is released to the receiving party (if the paying party has not referred the dispute to court or arbitration in that time)?  
**(One month as proposed / Other – please specify)**

Please indicate the reasons for your response and the impact on costs and project delivery across the supply chain it would result in.

## **Regulatory impact**

- Q10(i)** What would be the cost / benefit to your business and your projects of permitting the use “trustee stakeholder accounts” for adjudication awards in cases where the receiving party is insolvent, or will become insolvent before the dispute is finally decided?
- Q10(ii)** How often do you believe construction contracts contain clauses requiring adjudicator's decisions be paid into “trustee stakeholder accounts?”
- a)** More than one contract in 10?
  - b)** Between one contract in 10 and one in 100?
  - c)** Fewer than one contract in 100?
- How do you think this would change if the legislation were amended and what would be the impact (cost and risk) on companies in the supply chain?
- Q10(iii)** How often do you believe these clauses result in a party deciding against referring a dispute to adjudication where it would otherwise have been referred?
- a)** More than half of disputes?
  - b)** About half of disputes?
  - c)** Fewer than half of disputes?
- What is the cost / benefit to the industry and to delivery of projects of this practice?
- Q10(iv)** How often do you believe an award is made at adjudication where the receiving party is in insolvency proceedings?
- a)** More than one adjudication in 10?
  - b)** Between one adjudication in 10 and one in 100?
  - c)** Fewer than one adjudication in 100?
- Q10(v)** How would this figure change if we included cases where the receiving party would be deemed to be likely to become insolvent in spite of receiving the adjudicator's award compared to the number already insolvent?

## **11. Providing the adjudicator with the power to rule on certain aspects of his own jurisdiction and providing a right to payment in cases where the adjudicator stands down due to lack of jurisdiction.**

### **The issue**

- 11.1 The review considered the frequency of jurisdictional challenges during adjudications and at enforcement proceedings. It is relatively common to challenge the adjudicator's jurisdiction to decide the dispute, for instance by questioning:
- whether there is a construction contract for the purposes of Sections 104 and 105 (and possibly 106) of the Construction Act;
  - whether the contract was in writing for the purposes of Section 107 of the Construction Act;
  - whether there is a dispute;
  - whether the adjudicator was properly appointed.
- 11.2 An adjudicator's jurisdiction derives from the contract between the parties, which must comply with the Construction Act. Although some contracts provide the adjudicator with discretion to decide the issues above, there is no requirement in the Construction Act that they should do so. There is also no provision in the Scheme giving the adjudicator the discretion to rule on whether he has jurisdiction in any other area. Consequently enforcement of an adjudication decision can be refused if a court concludes that the adjudicator did not have jurisdiction. The review was unable to agree what, if any, change to the Construction Act should be made.
- 11.3 A further issue considered by the review was whether an adjudicator should be entitled to payment if he stands down in response to a challenge to his jurisdiction. At present an adjudicator's entitlement to payment only arises under his contract with the parties at his appointment or under the Scheme. The Scheme only makes limited provision for payment to an adjudicator on his resignation. Following the consultation on "Improving Adjudication in the Construction Industry" in 2001 we agreed to bring forward an amendment allowing the adjudicator to be entitled to payment under a framework covering this circumstance which would be set out in the Construction Act (see the introduction).

## Proposed way forward

11.4 An amendment to the legislation allowing jurisdictional challenges to be resolved during the adjudication and preventing them from being raised at enforcement is a significant step. Such an amendment would only be appropriate if we could be satisfied that the adjudicator was in a position, in all circumstances, reasonably to be expected to make correct and reliable decisions on this matter. A possible way forward would therefore be to amend the legislation so as to provide the adjudicator with powers to decide whether he has jurisdiction to decide the dispute only in relation to the following questions:

- whether there is a construction contract for the purposes of Sections 104 and 105 (though not 106) of the Construction Act;
- whether there is a dispute;
- whether the adjudicator was properly appointed.

The adjudicator's decision of these issues would effectively be final, and his decision of the dispute still enforceable, even if he was wrong on the jurisdiction point. However, the adjudicator's decision on the dispute could still be reopened at arbitration or litigation, just as at present.

11.5 If this proposal were taken forward, we would propose that the adjudicator should be compelled to make a decision on his jurisdiction in these areas. If the adjudicator were decided that he did not have jurisdiction to decide the dispute, either when his jurisdiction has been challenged or through his own consideration, he should immediately stand down.

11.6 We also propose that the adjudicator should be entitled to payment should he stand down under the powers described above. In these circumstances the adjudicator has fulfilled part of his legal responsibility under the Construction Act and should be paid accordingly. The legal entitlement to payment in this situation would also protect the adjudicator from the accusation that any decision on his jurisdiction could be biased by the fact that he might not be paid. It would also encourage matters of jurisdiction to be raised early in the adjudication by the parties or the adjudicator. In all other areas, we do not believe the legislation should change the current arrangement where the adjudicator does not have a legal entitlement to payment upon resignation.

11.7 In response to all other jurisdictional challenges, we believe adjudicators should continue to act in line with best practice. Guidance to adjudicators states that, in response to a challenge to their jurisdiction under the current law, an adjudicator ought to make a non-binding decision. This is based upon case law, which argues an adjudicator might otherwise be found to have failed to have acted impartially by ignoring a jurisdictional challenge from a party, simply because the adjudicator did not have the power to make a binding decision. Where an adjudicator makes a decision on his jurisdiction on these wider grounds, the parties should decide whether or not the adjudication should continue. The parties may revoke the adjudicator's appointment by agreement and must then pay the adjudicator. We propose that the adjudicator's entitlement to payment in this case, which currently features in the Scheme, should feature in the Construction Act as a requirement of all contracts, with the adjudicator's other payment entitlements, following revision of the legislative provisions on the adjudication costs.

### **Scheme for Construction Contracts**

11.8 We are proposing to provide the same jurisdiction to adjudicators acting under the Scheme to that which we are proposing to provide in the Construction Act. It may be necessary to make a parallel amendment to the Scheme to achieve this. Similarly, given that we are proposing to provide all of the adjudicator's legislated entitlements to payment in the Act in the same way that they are provided under the Scheme, any amendment to the Scheme will simply be for the purposes of consistency.

### **Alternative proposals**

11.9 While the guidance to adjudicators advises that an adjudicator should inform the parties if he is not sure he has jurisdiction, we do not believe an adjudicator should have a legislated entitlement to payment in this case. We believe it is incumbent on the adjudicator to make an early assessment of his jurisdiction based on the wider issues we are not proposing to include in the legislation and that payment should only be safeguarded in relation to payment for decisions on jurisdiction set out in the legislation. It is open to one or both parties to decide to pay the adjudicator and the adjudicator may also set out the basis on which payments should be made in his terms of appointment for agreement by the parties. It may be necessary to produce further guidance on this issue.

## Consultation questions

- Q11.1** Do you believe an adjudicator should have...
- a) ...no power to make a final and binding decision of his jurisdiction?
  - b) ...power to make a final and binding decision of his jurisdiction only in certain areas?
  - c) ...power to make a final and binding decision of his jurisdiction in any area?
- What would be the impact of this approach on members of the supply chain or on the likely completion of projects?
- Q11.2** Do you agree with the principle that an adjudicator should only have the responsibility to make binding decisions in response to jurisdictional challenges in areas where there can be confidence in his ability to make a correct and reliable decision? **(Yes / No)**
- Q11.3** Given the principle in Q11.2, do you agree that adjudicators could be expected to make correct and reliable decisions on the following grounds:
- a) ...whether there is a construction contract for the purposes of Sections 104 and 105 of the Construction Act? **(Yes / No)**
  - b) ...whether there is a dispute? **(Yes / No)**
  - c) ...whether the adjudicator was properly appointed? **(Yes / No)**
- Q11.4** Please explain your answer and indicate if you think there could be any complications or circumstances in which this would not be feasible? Please indicate if you think there are other circumstances in which the adjudicator would be in a position to decide on jurisdiction and whether there are circumstances in which this might not apply?
- Q11.5** Do you believe there are other questions an adjudicator could be relied upon to decide correctly if included in challenges to his jurisdiction? **(Yes – please specify / No)**
- Q11.6** Do you believe that the legislation should make explicit the adjudicator's right to payment in any of the following circumstances:
- a) when standing down after deciding he does not have jurisdiction?
  - b) when standing down after making a binding decision that he does not have jurisdiction under the proposal?
  - c) when standing down with the agreement of both parties to the contract (as at present)?

## Regulatory impact

- Q11(i)** How often do you believe adjudicators make non-binding decisions as to their jurisdiction?
- a)** in 95 – 100% of adjudications;
  - b)** in 75 – 95% of adjudications;
  - c)** in 50 – 75% of adjudications;
  - d)** in 25 – 50% of adjudications;
  - e)** in 5 – 25% of adjudications;
  - f)** in 0 – 5% of adjudications;
- Q11(ii)** How often do you believe a jurisdictional challenge relates largely to:
- whether there is a construction contract for the purposes of Sections 104 and 105 of the Construction Act; and / or
  - whether there is a dispute; and / or
  - whether the adjudicator was properly appointed;
    - a)** More than half of jurisdictional challenges;
    - b)** About half of jurisdictional challenges;
    - c)** Fewer than half of jurisdictional challenges;
- Q11(iii)** What other jurisdictional challenges are common within the adjudication process? To what degree would amending the legislation in these areas reduce the number of challenges or referrals to Courts to overturn decisions?
- Q11(iv)** How often do you believe jurisdictional questions are the main arguments forcing an adjudication to go to enforcement?
- a)** More than half of enforcements
  - b)** About half of enforcements
  - c)** Fewer than half of enforcements
- Q11(v)** How often do you believe a jurisdictional challenge is correct when made at adjudication or enforcement (irrespective of the outcome)?
- a)** More than half of jurisdictional challenges
  - b)** About half of jurisdictional challenges
  - c)** Fewer than half of jurisdictional challenges
- Q11(vi)** What do you believe to be the average total cost of enforcement proceedings to the parties? (£)

## 12. Providing the adjudicator with the power to reopen "final and conclusive" decisions where these are of substance to interim payments only

### The issue

- 12.1 Contracts can be drawn up containing clauses that allow adjudicators to "open up, revise and review any decision taken or any certificate given by any person referred to in the contract". Under many contracts, and the Scheme, this is limited and the adjudicator cannot exercise this power where "the contract states that the decision or certificate is final and conclusive".
- 12.2 Parties sometimes press for the inclusion of more clauses making decisions or certificates "final and conclusive" so as to limit the issues that adjudicators can open up. These clauses therefore can have the effect of removing the possibility that the payment could be subject to adjudication. This is mainly a matter for the parties, but such clauses seem to be of no benefit where the decision or certificate only affects an interim payment. An interim payment can be rectified in any event by a subsequent interim payment or when the final account is determined.
- 12.3 It makes sense for a contract to state that a decision is "final and conclusive" where the decision relates to the valuation of the final account under the contract. This is commonplace and valuations are usually certified by a supervising officer. We do not intend to change this practice which provides the parties with the security that the contract and all payments have finally been completed once the final account is determined.

### Proposed way forward

- 12.4 We propose to amend the Construction Act to provide the adjudicator with the power, similar to that under the Scheme, to "open up, revise and review any decision taken or any certificate given by any person referred to in the contract". However we would propose to provide the exception currently in the Scheme with an additional qualification so that the adjudicator would have the above power unless:
- a) 'the contract states that the decision or certificate is "final and conclusive"; and,
  - b) the adjudicator concludes that the decision or certificate is of substance to a non-interim payment.

This exception would therefore allow adjudicators in all adjudications (not just those under the Scheme) to open up decisions or certificates which are of substance only to interim payments.

## **Scheme for Construction Contracts**

- 12.5 We would propose that the current power provided to adjudicators in the Scheme should be amended to reflect the new power proposed above for inclusion in the Construction Act.

### **Alternative proposals**

- 12.6 Having considered alternative proposals from the review (and previously in the development of "Improving Adjudication in the Construction Industry"), we have not been able to identify an alternative proposal that would deliver the objectives outlined above. We would be interested in knowing if respondents can identify further options.

### **Consultation questions**

- Q12.1** What, if any, benefits arise from the use of "final and conclusive" decisions for interim payments?
- Q12.2** Do you agree that unless a decision is of substance to a non-interim payment, the interim payment resulting from an adjudicators decision could be revised in a subsequent payment or in the final account? Are there any circumstances in which this might not be the case? If so, is there a mechanism by which this could be addressed within the proposal?
- Q12.3** Do you agree that the legislation should...
- a) ...allow adjudicators in all adjudications to open up decisions or certificates which are of substance to interim payments; or,
  - b) ... leave the matter to the contract between the parties as at present with the current provision in the Scheme allowing the adjudicator to open up only decisions and certificates that are not final and conclusive?

Please explain your answers.

- Q12.4** Do you have an alternative proposal, if so, please specify and outline the benefits of your proposed approach.

## Regulatory impact

- Q12(i)** How often do you believe contracts include clauses making decisions or certificates "final and conclusive" of matters that are only of substance to interim payments?
- a)** in 95 – 100% of contracts;
  - b)** in 75 – 95% of contracts;
  - c)** in 50 – 75% of contracts;
  - d)** in 25 – 50% of contracts;
  - e)** in 5 – 25% of contracts;
  - f)** in 0 – 5% of contracts;
- Q12(ii)** How often do you believe this is ...
- a)** ... usually intended as means to avoid adjudication.
  - b)** ... usually intended for another genuine benefit (please describe).
  - c)** ... usually included by mistake.
- Q12(iii)** If you believe there is another genuine benefit to the contract and have suggested it in answer to Q12.2 above, what do you believe it would cost the contracting parties if this benefit were denied them under a change in the law? (**£ per interim payment**)

## 13. Extending the adjudicator's immunity under the Construction Act to claims by third parties

### The issue

- 13.1 An adjudicator's immunity is provided by the Construction Act as a requirement of the contract between the parties in Section 108(4). It states that:

*"The contract shall also provide that the adjudicator is not liable for anything done or omitted in the discharge or purported discharge of his functions as adjudicator unless the act or omission is in bad faith, and that any employee or agent of the adjudicator is similarly protected from liability."*

- 13.2 This provision does not prevent someone who is not a party to the contract prosecuting the adjudicator. Third parties potentially affected by an adjudicator's decision include other members of the project supply team, particularly those in the same contract chain and supervising officers. Clearly, the third party could themselves seek adjudication on their contract if they believed that the impact of an adjudicator's decision made this appropriate. The solution suggested by the review is to amend Section 108(4) in order to provide the adjudicator with statutory immunity, of the kind provided to arbitrators by Section 29 of the Arbitration Act 1996. The wording for this immunity is largely the same but it is provided as a general immunity, rather than as a requirement of the contract between the parties.

### Proposed way forward

- 13.3 We propose to amend the Construction Act in order to provide the adjudicator with statutory immunity, as is provided to arbitrators by Section 29 of the Arbitration Act 1996. This would replace of the current requirement for contractual immunity in Section 108(4) of the Construction Act

### Scheme for Construction Contracts

- 13.4 The review raised the question of whether the adjudicator's current immunity protects him from claims of professional negligence. We believe that the current wording already provides the necessary protection.
- 13.5 Finally, the review proposed providing adjudicators with protection from the possibility of being called as witnesses in court. We have no intention of taking this forward.

### **Consultation questions**

**Q13.1** Do you agree that the adjudicator should be provided with statutory immunity, as is provided to arbitrators by Section 29 of the Arbitration Act 1996 in place of the current requirement for contractual immunity in Section 108(4) of the Construction Act?

**Q13.2** Are you aware of instances where the possibility of a third party claim against an adjudicator has had an adverse effect on the adjudication?  
**(Please give details)**

**Q13.3** If you believe the adjudicator should not be immune from the possibility of actions being brought by third parties please explain why and what problems, if any, you believe would arise from providing this immunity.

### **Regulatory impact**

**Q13(i)** How often do you believe an adjudication results in a real possibility that an action could be brought by a third party (irrespective of whether such an action is brought)?

- a)** in 95 – 100% of adjudications;
- b)** in 75 – 95% of adjudications;
- c)** in 50 – 75% of adjudications;
- d)** in 25 – 50% of adjudications;
- e)** in 5 – 25% of adjudications;
- f)** in 0 – 5% of adjudications;

**Q13(ii)** How often do you believe third party actions are brought?

- a)** More than one in 100 adjudications?
- b)** Between one in 100 and one in 1000 adjudications?
- c)** Fewer than one in 1000 adjudications?

**Q13(iii)** Do you agree that adjudicators require additional protection under the legislation from claims of professional negligence? If so, please say why and what this would cost.

## 14. Applying provisions on adjudicator independence from the Scheme for Construction Contracts to all adjudications under Section 108 of the Construction Act

### The issue

- 14.1 Under most adjudications, there are requirements relating to the adjudicator's independence. Under Paragraph 4 of Part II of the Scheme for Construction Contracts the requirement is that:

*"Any person requested or selected to act as adjudicator in accordance with paragraphs ... shall be a natural person acting in his personal capacity. A person requested or selected to act as an adjudicator shall not be an employee of any of the parties to the dispute and shall declare any interest, financial or otherwise, in any matter relating to the dispute."*

- 14.2 However some contractual adjudication processes do not make a similar requirement for the adjudicator to be "independent". Section 108(2)(e) of the Construction Act requires that all contracts *"impose a duty on the adjudicator to act impartially"*. This relates to the adjudicator's treatment of the parties during the adjudication. An adjudicator could be connected to one of the parties, and not be independent, but in practice act impartially. Equally where an adjudicator is independent of the parties, this does not mean that the adjudicator will be certain to act impartially.
- 14.3 We believe applying a "double test" of impartiality and independence will allow greater security that the process is being conducted fairly. This seems appropriate given the private contractual nature of adjudication and its necessary speed.

### Proposed way forward

- 14.4 We propose that the current provisions on adjudicator independence in the Scheme for Construction Contracts should be replicated in the Construction Act as a requirement of all contractual adjudication processes. This provision is well tested under Scheme adjudications.

### Scheme for Construction Contracts

- 14.5 Under the above proposal there would be no requirement for an amendment to the Scheme for Construction Contracts as the current wording would automatically be consistent with that in the Construction Act.
- 14.6 We are concerned that the adjudicator should retain all of the powers and fallbacks currently available in the Scheme to manage the process swiftly in a fair and economical way. Though the review group recommended amending the current restriction on the numbers of representatives attending adjudicator's hearings, we have concluded that the current wording is satisfactory as it allows the adjudicator discretion to decide on numbers on a case-by-case basis in this area.

## **Alternative proposals**

- 14.7 It would be possible to replicate in the Construction Act only some of the elements from the test of independence in the Scheme. The Construction Act could simply require the adjudicator to declare their interests or require that the adjudicator should not be an employee of either of the parties to the dispute. Respondents may also wish to suggest alternative requirements to be made in the Construction Act or Scheme in order to ensure adjudicators are independent.

## **Consultation questions**

- Q14.1** Do you agree with the proposed amendment to replicate the Scheme test of independence in the Construction Act? What do you believe will be the impact of this amendment? Would it reduce access to adjudicator expertise for specific types of dispute for example? Would it potentially increase costs to any parties?
- Q14.2** Would you prefer to leave the legislation as it stands? If so, please say why.
- Q14.3** If you believe a further test of independence is needed but not going as far as the proposal, what form should it take?
- a) adding the requirement in Paragraph 4 of Part II of the Scheme for adjudicators to declare their interests?
  - b) adding the Scheme requirement that adjudicators cannot be employees of the parties?
  - c) Another form of amendment (please specify and give reasons for your answer)

## **Regulatory impact**

- Q14(i)** How often do you believe adjudications are conducted where the adjudicator would fail the requirement for independence in the Scheme for Construction Contracts?
- a) In 95 – 100% of contractual adjudications.
  - b) In 75 – 95% of contractual adjudications.
  - c) In 50 – 75% of contractual adjudications.
  - d) In 25 – 50% of contractual adjudications.
  - e) In 5 – 25% of contractual adjudications.
  - f) In 0 – 5% of contractual adjudications.
- Q14(ii)** What would be the impact of the alternative proposals on these figures?
- Q14(iii)** If you believe that widening the test for independence would reduce the availability of adjudicators for any particular types of adjudication, please say what you believe the cost of this might be to the industry (in terms of ability to use the adjudication process, impacts on time, payments, access to resolution mechanisms etc).

# ANNEX 1 – Regulatory Impact Assessment

## 1. Title of proposal – Consultation on "Improving Payment Practices under the Construction Act"

### 2. Purpose and intended effect of measure

#### (i) The objective

To identify how best to reduce delayed and disputed payments in the construction industry by encouraging better payment practice with more correct payments are made on time, fewer disputes and swifter dispute resolution. All this is intended to improve cash flow down the construction supply chain which is recognised as key to project delivery on time and to budget. It can also act as an enabler to improve quality, encourage innovation and facilitate best practice.

This will be achieved by addressing concerns about the effectiveness of the adjudication and payment provisions of Part II of the Housing Grants, Construction and Regeneration Act 1996 and The Scheme for Construction Contracts (England and Wales) Regulations 1998.

The DTI plans to consult on how to take forward a range of proposals to improve the operation of legislation. These were developed following the first stage of a review of the legislation by a group drawn from the construction industry and its clients and chaired by Sir Michael Latham.

This RIA considers two options for the introduction of the DTI's consultation package of legislative proposals. As an alternative non-legislative route to addressing the issues raised by the Latham review, the RIA also considers the possibility of issuing guidance on how the issues could be addressed under the legislation in its present form.

#### Devolution

Though the Construction Act covers Scotland, England and Wales, responsibility for the legislation in Scotland has been devolved to the Scottish Parliament. We have agreed with the Scottish Executive that this consultation process should not cover Scotland. The Executive will take forward a separate process in relation to Sir Michael Latham's recommendations.

Following devolution, changes to the primary legislation enacted by the UK Parliament and proposed by DTI Ministers will apply to England and Wales only. The Welsh Assembly will also have to give consent to the commencement of the amended legislation following consultation of stakeholders in Wales. This is because the legislation is devolved to Wales. However amending the primary legislation falls to the UK parliament.

Given this situation, we have agreed with the Welsh Assembly Government to conduct the consultation jointly.

There is a possibility that, once finalised, improvements to the construction contracts legislation in England and Wales may be made through a Regulatory Reform Order (RRO) under the Regulatory Reform Act 2001. The RRO would also be able to make amendments to secondary legislation in England and Wales. The whole package would then require the approval of the National Assembly for Wales.

#### (ii) The background

The context for this proposal was originally set by Sir Michael Latham's report "Constructing the Team" (1994) which recommended the introduction of the statutory right to refer construction disputes to adjudication in the Construction Act. Latham's overall approach to improving the performance of the construction industry was subsequently reinforced by Sir John Egan in "Rethinking Construction" (1998) and "Accelerating Change" (2002) and is being taken forward today through the Strategic Forum for Construction.

At the heart of all these initiatives is partnering, collaboration and integrated team working on construction projects. These approaches are also the core of Government policy for the industry, and are widely and publicly supported by a growing number of clients, both public and private sector. Naturally, an integrated and partnered team will approach cost (and thereby also payment) issues on an open book basis. In this context, there can be no place for poor payment practices.

When the Construction Act went through Parliament in 1995/6, these new approaches were only just beginning to take root. They have spread rapidly in the last few years, with the Construction Act reinforcing best practice and also ensuring a fair balance in commercial power throughout the demand and supply chain in certain key areas.

However, in the years since the Construction Act came into force on 1 May 1998, a number of difficulties have come to light in certain sectors of the construction industry. Concerns about the effectiveness of the legislation at improving the payment process gave rise to the announcement of a review of the legislation in the government's Budget of March 2004. The Budget report stated that:

"Following concerns raised by the construction industry about unreasonable delays in payment, the government will review the adjudication and payment provisions of the Housing Grants Construction and Regeneration Act in order to identify what improvement can be made."

Delayed and disputed payments and adversarial and litigious business practices are problems widely experienced by firms in the construction industry. The payment and adjudication provisions of Part II of the Housing Grants, Construction and Regeneration Act 1996 (the Construction Act) were devised to improve this situation by:

- requiring that construction contracts provide an adequate mechanism to establish what will be paid and when;
- providing a statutory right to stage payments on construction contracts over more than 45 days;
- requiring a notice to be served in advance of withholding payment;
- providing a statutory right to refer disputes under the contract for resolution through a 28 day adjudication process;
- providing a statutory right to suspend work in cases of non payment without notice;
- rendering "pay-when-paid" clauses in contracts unenforceable other than in cases of upstream insolvency;

The legislation has been widely welcomed since it came into force on 1 May 1998. The adjudication process in particular appears to have reduced the number of disputes reaching the courts (reportedly cutting the waiting list for cases at the Technology and Construction Court from two years to six months). However, payment practices in the construction industry continue to cause concern. Problems of disputed, late and non-payment continue to be commonplace.

In April 2004, the DTI's Construction Minister, Nigel Griffiths appointed Sir Michael Latham, the original architect of the legislation, to undertake the initial industry consultation phase of the review to inform a formal public consultation by the government later in the year. That process was completed on 17 September 2004 when Sir Michael reported his findings to the Minister.

The review proposed a large number of amendments to both primary and secondary legislation. The government now intends to take forward the first public consultation, on the broad policy of the amendments.

After Sir Michael Latham was appointed to undertake the review, he quickly established two working groups respectively looking at the payment and adjudication provisions of the legislation. Though the adjudication working group also made a point of looking at the scope of application of the legislation, Sir Michael Latham later agreed with the Construction Minister, Nigel Griffiths that consultation on these proposals should not be taken forward.

### **(iii) Risk assessment**

#### **The key risks being addressed (and hopefully reduced) by the package of improvements proposed for consultation are that\*:**

The construction industry continues to suffer from delayed and disputed payments. This has a negative impact on the industry as it can frustrate cash flow and lead to litigation. The evidence from a number of reports to Sir Michael Latham's review of the Construction Act is that a number of practices are intended to avoid complying with various requirements of the construction contracts legislation. The intention is to delay or reduce the payments under the contract or to delay or reduce the payments that are actually made. The disputes which follow can disrupt project performance and waste time and resources. The Latham review concluded that unless certain loopholes are closed, the construction industry and its clients will continue to suffer from inflated costs and delayed performance as a result of common payment problems. These problems congregate around issues of:

- failure to agree what should be paid and when;
- the ability to manage cash and enable completion of the project;
- disincentives to referring disputes to adjudication;

The review heard that these issues particularly affected subcontractors. Subcontractors use the adjudication process more frequently than any other group in order to resolve disputes with their employers. Larger firms are more likely than smaller firms to undertake main contracting work. The largest firms in the construction industry take significantly longer to pay invoices.

#### **Risks associated with issuing guidance as a non-regulatory route to address the problems raised by the Latham review**

Publishing Guidance on the legislation as an alternative to further legislative intervention is considered in annex B. To summarise the key risks these are that:

- Guidance could raise awareness of loopholes in the legislation among those who could take advantage of them as well as those who could avoid them.
- Guidance cannot eliminate the use of undesirable contracting practices, only discourage it. It is unlikely to reach everyone in the industry so most poor practices will persist.
- Where good practice in guidance puts firms at a short term competitive disadvantage, they may choose to ignore it.

### **Risks of unintended consequences as a result of legislative changes**

At present, prior to consultation, the key risks of this package can only be indicated. Risks of unintended consequences may come to light during the consultation process but several possible undesirable consequences, related to specific measures, were raised during discussions with Sir Michael Latham's review group. The consultation paper will consider these in more detail. However, two specific risks were identified in relation to a number of proposals:

- **increase in construction insolvencies due to persistence in poor cash flow management practices under a new regime.** Given the position of many contractors in the middle of contract chains, cash flow management is vital to the construction process. This legislation is in part intended to improve cash flow management in the construction industry. It is clear that many skilful managers schedule work, make prompt payments, manage credit, and manage cash flow effectively, by legitimate means, so as to avoid difficulties. However, indications are that practices such as late or non-payment and avoidance or abuse of the legislation are also common and can allow contractors to secure their cash position at the expense others in the supply chain. It follows that these contractors are more likely to encounter serious cash flow problems, and possibly insolvency as the legislation is tightened up. In the short term, this may simply be a "bedding down period", which would hopefully be minimised by publicity during the period that the legislation comes into force. However, in the long term the intention of the changes is to reduce the incidence and impact of late and non-payment of insolvency in the construction industry.
- **Increases in payment periods.** For a number of good reasons and consistent with other DTI legislation on late payments, it is inappropriate to place limitation on the maximum length of contractual payment periods as some in the construction industry have suggested. Surprisingly, it has been suggested that payment periods may increase as the legislation better enables the determination of the payment due under the contract between the parties. Whether this lengthening is agreed in contracts or results from late payment, it is suggested that payers may wish to safeguard their cash position in the process in this way. This could be an indirect and unintended consequence of improving the legislation and if payment periods were to increase it could be considered to frustrate the objectives of the legislation. Though there is a legitimate need for payment periods to cover the period in which payment applications are made up the contract chain and payments are distributed down it, the intention should be to bring about a reduction in this period as the legislation is improved.

Other additional risks which the proposals already seek to address but which we will also consider include:

- Over prescriptive impositions on contractual freedom and innovation;
- Shifting regulatory burdens and contractual risks between sectors and groups rather than reducing their overall impact.
- Artificially shifting the bargaining power in current contractual relationships between different sectors of the construction industry.

These are considered in the consultation paper in relation to specific measures:

### **3. Options**

The consultation paper considers options in relation to each issue raised and discuss their various advantages and disadvantages in the main body of the text seeking responses from consultees. For the purposes of this Regulatory Impact Assessment, we believe it is sufficient to consider three basic packages of recommendations based on the content of the review.

#### **Option 1: Maintain the legislation as it stands and take forward a voluntary process of improving construction contract and payment practices through the publication of Guidance on the legislation and support for other voluntary industry improvement programmes**

This would most likely include the use of guidance to encourage best practice in the agreement of construction contracts and the use of the existing provisions of the Construction Act.

There are clear business drivers already well established by the DTI's Rethinking Construction initiative for adopting a best practice approach to construction contracting. Much of the work of the DTI over recent years has promoted this and the DTI continues to oversee and support a number of improvement programmes in the construction industry.

The area of best practice most closely related to the areas addressed by the Construction Act is termed the "open book" approach to the valuation of work under contracts. The effect of this approach is to allow contracting parties to know what applications for payment up the supply chain are comprised of, how work is priced, profits generated and what payments are being made and received. For instance when payment is made to a contractor for a subcontractor's work the subcontractor will be aware of what payment has been made in respect of his work and why. The effect is that everyone on the project knows what issues have arisen between the parties, what role they have in addressing these and how to manage any effect on them or their work.

These practices are far in advance of the very basic improvements of the payment process which are being sought in response to the recent review of the Construction Act. It has generally proved difficult to address problems related to payment in the industry and narrowing the gulf between the best practices, such as these, and the worst, which are affected by the Construction Act is a long process. It is the intention of the legislation simply to raise the baseline in the construction industry, rather than to advance the practices of companies above that line to a stage where they are among the best and most innovative.

However, it has been recognised on a number of exemplar projects that good management in which payment runs smoothly are key to developing trust within supply chains. This then allows those chains to work together in the most effective and integrated ways and reduce waste and costs on their projects. In bringing about modest improvements in payment, legislation can act as a catalyst to more general improvements in industry performance. We therefore see the two processes of raising the baseline on payment and encouraging innovation and best practice as going hand in hand.

In order to further improve general payment practices in the construction industry, following the introduction of the legislation the DTI supported the publication of Guidance to Adjudicators and the Parties to Adjudication. In addition to the legislative proposals considered in this consultation exercise the DTI also intends to support the production of further and revised Guidance on the legislation. Guidance is considered in this RRO as the main alternative to further legislative intervention.

**Option 2: Identifying a simple package of legislative measures with low regulatory impact, with a view to introduction following further consultation.**

The proposals in this consultation are aimed at improving the ability of parties to a construction contract to:

- Reach agreement on what should be paid and when given the work done under the contract or, where they cannot agree, to make an informed referral to, or response at, adjudication;
- manage cash flow and enable completion of work on the project in the event of problems such as defaulted payments, disputes or insolvencies elsewhere in the supply chain;
- refer disputes to adjudication without disincentives such as avoidance, frustration or unnecessary challenge.

This option is intended to fulfil each of these aims in a relatively simple way, where there would be clearly understood limits on the potential regulatory impact. The package under the option would be clear enough to be introduced on a relatively short timescale, parliamentary time permitting. However, there are a number of areas where the review generated less agreement on how (and whether) the issue in question justified legislative intervention.

The consultation will therefore need to identify a broad measure of support for a package of clearly described measures if this option is to be preferred. Such a package may only be a subset of the consultation proposals considered in this initial stage, but could potentially be a larger number.

Were such a package available following the completion of the first consultation, it may be capable of implementation through a Regulatory Reform Order. Appendix 2 describes issues specifically related to the potential use of a Regulatory Reform Order to amend the legislation.

**Option 3: Introducing a wider package of proposals to have emerged from the Latham Review of the legislation managing the potential regulatory impacts**

A package under this heading would be intended to fulfil the same aims described above in relation to improving payment and adjudication in the construction industry. However following consultation it may become clear that specific issues are of such a priority that they need to be addressed in spite of the extensive and complex regulatory impacts involved.

A number of issues raised in the review go to the heart of the operation of the legislation and raised significant discussion on the review group between different sectors in the construction industry with significantly different interests. A number of these proposals arising from the review in this area will require significant development and could be subject to additional debate at a second consultation phase when they have been worked up further.

The package under this option would be likely to include a more complex set of interrelated measures. Though it would still be intended to improve the current regulation overall, it would involve a complex picture of regulatory impacts. A number of the proposals would have to be crafted quite carefully to only apply appropriate regulatory burdens and the package as a whole would still have to be weighed carefully for its effects on specific groups as well as the overall benefit.

It is still hoped that this package, addressing many more of the issues raised by Sir Michael's Latham's review, could be introduced via a Regulatory Reform Order. However there is also a possibility that a package as described here could be preferred even if it cannot satisfy the stringent tests of the RRO process and another legislative mechanism is needed.

#### **4. Benefits**

**Option 1: Maintain the legislation as it stands and take forward a voluntary process of improving construction contract and payment practices**

The key benefits of a guidance approach to the issues raised by the review of the Construction Act are:

- Improved information and awareness of the problems caused by agreeing undesirable contract terms;
- Clarification of the current law on contracts evidenced in writing;
- Greater awareness of the potential for third party actions against adjudicators;
- Advice and clarification (so far as is possible) of what an adequate mechanism should consist of under the current law, with Section 110(2) still in place, raising awareness of the limitations on payees addressing a payer's failure to serve a payment notice.
- More informed non-binding decisions by adjudicators on their jurisdiction.

The consultation will attempt to evaluate the extent to which these benefits would improve the industry's situation.

The evidence from a number of reports to Sir Michael Latham's review of the Construction Act is that a number of practices are intended to avoid complying with various requirements of the legislation or avoid the full extent of its improvement of the payment process further down the supply chain.

Guidance and awareness raising can combat some of these practices to an extent. However they cannot eliminate them completely. For instance some practices, such as those involving pay-when-certified type clauses are entered into voluntarily by a party, who may have no foreknowledge of the possible effects. Though contractors who have experience of the legislation or who seek advice will therefore benefit from guidance, the problem is likely to persist elsewhere. The question is one of the extent to which it would be appropriate for the practice to be reduced rather than eliminated.

**Option 2: Identifying a simple package of legislative measures with low regulatory impact, with a view to introduction following further consultation.**

The key benefit of a package like this would be that it:

- could have a broad measure of support from across the construction industry;
- could consist of measures which are close to being finalised in their detail at this consultation stage, cutting potential delays;
- could be implemented on a shorter timetable with one further consultation stage on draft clauses only

**Option 3: Introducing a wider package of proposals to have emerged from the Latham Review of the legislation managing the potential regulatory impacts**

It is proposed that this package should consist of many more of the proposals which the DTI is taking forward for consultation following the Latham review. The benefits of each of the measures in the package are summarised in the consultation paper.

Overall the benefits of a package like this would be that it could:

- effectively address the full range of issues facing the industry as identified by Sir Michael Latham's review and identified as practicable for improvement;
- raise the baseline of performance in the construction industry as far as is practicable at the present time;
- Introduce workable solutions to some of the more complex problems facing the construction industry in relation to payment.

**Business sectors affected**

These amendments will apply to all construction contracts within the scope of Part II of the Housing Grants, Construction and Regeneration Act 1996. In general all the measures contained in Part II of the Act apply to all construction contracts within the definition contained in Sections 104-106 and in The Construction Contracts (England and Wales) Exclusion Order 1998. Though some of the original provisions are slightly more limited in their application, and some proposed improvements are similarly limited, All contracts to which the Construction Act applies will be affected significantly by the proposed improvements.

The legislation applies to contracts for construction work and construction professional services including mechanical and electrical work and civil engineering and groundworks. It does not apply to supply only contracts for construction products or materials. A table of economic figures for these sectors is set out below. However the contracts for these services may well be made with construction clients in other business sectors (the legislation does not apply to domestic clients).

Clients are not considered in the assessments of numbers of firms in this table.

Contracting Services	Construction Professional Economy	Construction of Whole	Total %
Number of Enterprises	195,595	18,510	11%
% of small or micro enterprises	98.9%	92.8%	
Total Turnover	£142,463m	£8,130m	6.8%
Gross Value Added	£50,611m	£4,448m	5.9%
% of output** funded by public sector	30%	26%	
Average Employment	1,307,000	131,000	5.6%
Total Net Capital Expenditure	£3,950m	£215m	4.8%
Number of company insolvencies	1,840	Not available	11.3%*

\*Based on contracting only

\*\*Based on DTI output survey for contracting and CIC survey of construction professional services

### **Issues of equity and fairness**

These proposals address one of the key inequalities in the construction industry, that of bargaining power between the parties to construction contracts. There is a general distortion of the construction market whereby a dominant party to a construction contract is able to abuse his position by negotiating terms which go against what would otherwise be the overriding interests of the industry within the client supplier relationship.

Whereas many commercial relationships are based on incentives to improve service and compete with other suppliers for higher profits, the construction industry suffers from extensive problems of poor performance (in particular on project cost and time overruns) and low profits. In this very competitive environment, bargaining power enables some contractors to negotiate more favourable contract terms which may compromise service further but enable them to maintain their cash position at the expense of other members of the supply chain. The construction contracts legislation was intended to create a baseline level of fairness in all construction contracts in order to improve opportunities for projects to be completed on time and to budget without suffering from business practices that can compromise delivery.

However following the legislation more powerful contracting parties have begun to insist on contractual terms and conditions, which have the effect of preventing or dissuade the other party from exercising his statutory right to adjudication or frustrate the process of ascertaining the amount to be paid. It is important to emphasise that these dominant parties in a construction contract can be at any point in the supply chain, though in practice payers are better placed than payees to abuse their position through late and non-payment.

## **5. Costs**

### **(i) Compliance costs**

#### **Option 1: Maintain the legislation as it stands and take forward a voluntary process of improving construction contract and payment practices**

Generally in the past the guidance documents published on the adjudication process have been well received and have allowed adjudicators and the parties to an adjudication greater security in taking forward the process in line with the guidelines provided. However, the guidance was intended to be more informative as to the choices faced by adjudicators and the parties involved than it was to compel the parties to take specific actions. Given its status as guidance, while the compliance costs were minimal, its reception suggests that the improvements to the adjudication process brought about by the information provided to the parties has reduced unnecessary expense or unexpected costs overall, especially in those areas where the cost of adopting the guidance is relatively low. It is hard to see how many of the measures in this consultation, which involve up front expense on the part of the industry prior to any benefit, would be adopted through guidance alone.

Both the packages described in options 2 and 3 have been developed with this consideration in mind.

#### **Option 2: Identifying a simple package of legislative measures with low regulatory impact, with a view to introduction following further consultation.**

As already discussed in the benefits section on this option, the intention would be to ensure that all proposals in this package would be intended to be capable of introduction through a Regulatory Reform Order. This would mean that the balance between costs and benefits in the package would need to satisfy the requirements of the Regulatory Reform Act 2001 as summarised in Appendix 2. However, to summarise:

- The legislation should relieve at least one current regulatory burden;
- Where the legislation provides a new burden, the costs should be proportionate to the benefits;
- The package as a whole should balance the costs to any specifically affected groups against the wider benefits and be desirable in terms of the improvement it makes overall.

One particular consideration is whether any sector of the construction industry is disproportionately affected by the proposed measures. The DTI does not consider this to be a significant issue at present but will attempt to confirm this at consultation. The Latham review reported that dominant parties in construction contracts could in general be drawn from any sector of the construction industry. Furthermore, though the initial compliance costs of the legislation might affect small businesses more than others, the long term compliance costs are not dissimilar.

#### **Option 3: Introducing a wider package of proposals to have emerged from the Latham review of the legislation managing the potential regulatory impacts.**

The anticipated costs of the whole package of proposals resulting from Sir Michael Latham's review are considered in the body of the consultation paper in relation to the individual consultation proposals.

Were this package not to satisfy the stringent tests that would allow it to be implemented through an RRO, it would still be necessary to ensure that the costs justified the benefits, particularly in the long term.

### **(ii) Other costs**

The main beneficiaries of this policy are firms within the construction industry and regular clients to this industry. However when undertaking construction work, any commercial client benefits from an effective framework for payment and fair alternative dispute resolution procedure. All help to keep the payment process running smoothly and avoiding expensive and lengthy litigation. Almost all UK businesses and public sector bodies undertake construction work from time to time and are therefore potential beneficiaries. We would therefore be very surprised if costs to the wider economy were increased at all.

### **(iii) Costs for a typical business**

The typical construction company is small (98.5% have fewer than 50 employees), and works in plumbing, electrical wiring or in the general building trade (either domestic or non-domestic). It will work largely in the repair and maintenance sector, or as a subcontractor. Firms which work as main contractors for new work tend to work as general builders (either domestic or non-domestic) – 53% of them are classified as such, compared to 14% of those who are not main contractors for new work.

There appears to be a disproportionate affect on smaller firms, both of the legislation and of payment problems in the construction industry. In part this is due simply to the numbers of small firms in the construction industry. Also, adjudication is used most frequently by subcontractors to resolve disputes with their employers. "Adjudication the first forty months" by the Construction Industry Council found that half of all adjudications covered by the survey were of disputes brought by subcontractors against their employers. It is true to say that larger firms are more likely than smaller firms to be main contractors as the following figures describe.

It is difficult to give exact numbers of sub-contractors and main contractors as firms can easily operate as both, but DTI figures show that over 32,000 firms carry out at least some new work as main contractors, some 18% of the industry, while 82% of firms only undertake subcontract and repair and maintenance work. Main contractors tend to be slightly bigger (in employment terms) than firms which only do R&M or sub-contracting. 18.7% of them have ten or more employees and 3.6% have 50 or more. Only 8.9% of firms only involved in R&M and subcontracting have ten or more employees, while only 1% have 50 or more.

Costings are more difficult, as we have no figures on how much of the value of a main contract is passed on to sub-contractors. What we do know is that the 98.5% of the industry which are small firms, carry out 42% of the work and employ 56% of the industry.

Insolvency figures are published by DTI. In 2003, 1,808 construction companies were liquidated in Great Britain, out of a total 14,805 liquidations – that is 12.2% of all liquidations. Construction companies made up 10.8% of companies in 2003, so construction companies were slightly more likely to be liquidated than companies on average across other sectors. In England and Wales, there were 1,781 bankruptcies of self-employed construction workers, out of 9,139 self employed bankruptcies (in total 28,021 individuals were bankrupt) in 2003.

Though the average invoice payment time in the construction industry is comparable with that across the economy as a whole, payment times for large construction firms are considerably worse. Experian published figures on average payment period by sector and size of firm in July 2004. While large construction firms (200+ employees) took 87 days on average, compared to 78 days for large firms across the economy as a whole, the average for all firms in the industry was 58 days compared to 59.5 days across the whole economy. These figures reflect invoice payment times irrespective of the contractual payment period or any contractual arrangement for an application for payment is submitted in advance of a VAT invoice.

For a typical client (in any sector of industry), it is unlikely they will use the adjudication process often. As such, clarity and simplicity in the process are important in making it accessible and available for use when needed. The same is largely true for most construction firms, though they may be more likely to develop experience of adjudication over time. In order to be an effective part of the overall payment framework, the availability of adjudication is as important as the process itself in hastening prompt payment. In this respect, the benefits of the legislation are experienced far more widely because firms are likely to want to resolve disputes before they reach an adjudicator.

It is partly because firms do not have regular experience of the adjudication process and only benefit from its accessibility that they are prepared to accept contract terms that have the effect of frustrating the process. It is likely that firms regularly contracting out of what would otherwise be entitlements under the law because of the current existence of various loopholes. Many firms are likely to win work on this basis without suffering any consequences in the short term. This problem could be addressed to an extent through guidance though some firms would knowingly ignore guidance in order to complete with others who might be unaware of it.

The right to suspend work is rarely considered to be more than a last resort to be used relatively infrequently. However as such it should be accessible to firms and allow firms to take evasive action to manage cash flow when payment for their work is late. Suspension is also a clear disincentive to delaying payment and again is in part effective because of its availability as well as its use. Improving the right to adjudication and the suspension of work are clearly important for this reason.

A typical business comes into contact with the provisions of the Construction Act most frequently in relation to the framework for payment. The requirement for an adequate mechanism to establish what should be paid and when, the entitlement to stage payments on longer term contracts and the requirement to serve payment and withholding notices, all create a framework which is common in the experience of contractors. Most of this framework is not costly and was used less formally before this legislation originally came into force. However it does not in itself make money change hands. The intention to encourage a better flow of information about what payment is expected. This increase in information is intended to make the outcome at adjudication more certain as both the referral and response should be relatively informed.

The proposed improvements to this framework are intended to increase clarity and certainty of the payment process, prevent unnecessary disputes, and make adjudication even more effective as a last resort. The measures proposed are not intended to radically alter the process in principle and should decrease its cost of administration in most cases. Furthermore the process should be more adaptable to the needs of specific contracts, with the administrative costs better spent as a result.

## **6. Consultation with small business: the Small Firms' Impact Test**

There is potential in the construction contracts legislation for the impact of proposals to specifically on small businesses. This is a natural consequence of the industries that are affected, namely construction contracting and construction professional services, which respectively consist of 98.9% and 92.8% small and micro sized firms. The key question is whether there is a disproportionate impact on these firms given their smaller size compared to the larger firms in the industry. Significant issues for small firms appear to be:

- **Excessive and disproportionate costs following introduction of the proposed changes** – Though any change may have a disproportionate effect on smaller firms, these proposals are intended to reduce this as far as possible. Firms are not forced to alter the basis on which they contract by any of these proposals, though certain contractual terms may become unenforceable in court. Also the requirements of contracts under the legislation are not requirements for a specific response from the parties, the required terms can simply be read into the contract from the fallback Scheme for Construction Contracts.
- **Ongoing disproportionate costs to small firms** – the costs of administration associated with the payment provisions of the Construction Act are not considered to fall disproportionately upon small firms. In this respect it is most likely that the quantity of payment administration is proportionate to the amount of work. The costs of the adjudication have been a problem in the past as contractors have not necessarily been aware of the effect on the costs of the process of the contractual clauses they have agreed. Generally it is believed that the predictability of the payment process and the ability to plan cash flow are beneficial to small firms who can then spend less managing debt.
- **Excessive imbalances in market power affecting small firms.** DTI's current understanding is that the legislation currently goes some way to balancing what would otherwise be a common and unreasonable imbalance in market power in favour of larger firms in the industry. Discussions with Sir Michael Latham's Construction Act Review Group indicated that market power in construction largely works down the supply chain other than in situations where small clients take on large contractors, and where small contractors take on the specialist services of large subcontractors. Any exceptions tend to be for high value specialist services, though in each of these special cases the contractual relationship takes on a distinct character of its own. In relation to payment, it appears that the excessive imbalances in market power that exist in the industry have been addressed to a greater or lesser extent by the introduction of the Construction Act to the benefit of small firms. However it also seems that there are areas where the Construction Act has not done this as successfully as intended. In improving the Construction Act the proposed measures are not intended go further in addressing imbalances than the original legislation.

Sir Michael Latham's review group contained a number of representatives specifically from the construction small firms community and many others aware of issues specifically affecting small firms. The DTI is confident that small firms issues have been identified at this stage prior to consultation and will seek to explore these further at the consultation stage.

## **7. Competition Assessment**

There are no competition issues raised by these proposals. There is no dominant competitor in the construction sector. Competition is healthy to the point of sometimes being extremely fierce significantly affecting profitability. Similarly, there is no small key group of dominant firms in any subsector other than perhaps some very small specialist fields. The legislation does not set up barriers to entry to any sectors or to the construction industry and is unlikely to affect the size of firms or number, though it may reduce the churn brought about by the combination of insolvencies and new firms being established.

## **8. Enforcement and sanctions**

The DTI is not proposing to change the enforcement mechanisms introduced in the original legislation. The main enforcement mechanism for the legislation other than the courts or arbitration, is the adjudication process which the legislation provides. The decision of the adjudicator is binding on the parties and enforceable through summary judgement in court. This is a civil rather than criminal procedure.

## **9. Monitoring and review**

An Industry chaired group – the Construction Umbrella Bodies Adjudication Task Group (CUB ATG) – continues to monitor the effectiveness of the adjudication process and identifies areas where improvements are required. Though it does not include the payment provisions of the legislation within its remit, it may be willing to do so in the future. Along with the production of two sets of guidance (one for adjudicators, one for those going to adjudication), CUB ATG has lobbied strongly for the proposal to make provisions on the costs of adjudication since 2000 and most recently through Sir Michael Latham's review, in which it formed the core of adjudication working group. It is intended that DTI will continue to work with this group after the current review is completed.

## **10. Consultation**

### **(i) Within government**

Cabinet Office, Office of Government Commerce, Office of the Deputy Prime Minister, Small Business Service, Insolvency Service, Department for Constitutional Affairs, Scottish Executive, Welsh Assembly.

### **(ii) Public consultation**

It is intended to consult on the proposals as widely as possible within the construction industry, legal profession and construction client community.

In addition, as part of the pre-consultation phase of development of these proposals, the DTI convened Sir Michael Latham's review group to look at issues related to how the legislation was working in practice.

## 11. Summary and recommendation

It is not possible to make any form of recommendation until after the completion of this initial consultation. The intention is that the consultation will identify and further develop the . However, to summarise the options set out in this Regulatory Impact Assessment, there are three:

**Option 1: Maintain the legislation as it stands and take forward a voluntary process of improving construction contract and payment practice.** It is likely that guidance will become the preferred option in relation to some proposals, at least for an interim period. Other proposals, which have already been rejected as suitable for legislation are also likely to be dealt with through guidance.

**Option 2: Identifying a simple package of legislative measures with low regulatory impact, with a view to introduction following further consultation.** The intention behind a package would be that it could be implemented through a Regulatory Impact Assessment in relatively short time. It should therefore consist of measures which are have a consensus of support in the construction industry and can be finalised to the necessary level of detail quite easily. The regulatory impact of the measures should be well understood and individually and as a package they should satisfy the tests for suitability for introduction through an RRO.

If this is identified as the preferred option, issues not suitable for inclusion in this package will need to be dealt with either through guidance or, on a longer timescale through another regulatory route. Alternatively consultation may establish that the measure proposed is unsuitable or unnecessary.

**Option 3: Introducing a wider package of proposals to have emerged from the Latham review of the legislation managing the potential regulatory impacts.** It is still intended that, if possible this package should be introduced through a Regulatory Reform Order. However the priority here would be to introduce a package to address the clear priorities of improving payment practices in the construction and ensuring that no one firm or sector is gravely disadvantaged in the construction market place.

Sir Michael Latham's review of the legislation discussed a large number of issues on which it could not agree a clear recommendation as to how to move forward. As it is now down to government to identify how and whether these issues can be addressed, this package would be intended to go as far as possible in doing this successfully. The DTI will seek broad support from the construction industry and intends to use the consultation process to achieve this. However, given the possibility of a more complex balance of regulatory impacts and of continuing controversy in some areas, a package of the kind described under this option may not be suitable for introduction through an RRO. This remains to be seen following consultation.

## 12. Declaration

*I have read the Regulatory Impact Assessment and I am satisfied that the benefits justify the costs.*

**Signed** ..... (This remains blank until the legislation is to be sent to Parliament. It then becomes a final RIA)

### Date

Hon Nigel Griffiths MP  
Parliamentary Under Secretary of State for Small Business, Construction and Enterprise

### Contact point

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## **Appendix 1 – Detailed costs and benefits of Option 1 – the publication of Guidance advising the construction industry on how some of the issues raised by Sir Michael Latham can be addressed voluntarily**

### **Benefits of guidance aimed at:**

**1. Raising awareness of the problems caused by agreeing undesirable contract terms** – About half of the problems in the operation of the legislation which Sir Michael Latham's review has brought to light result from parties agreeing terms in contracts either because they are unaware of their potential effects or because they accept the risk that they will be disadvantaged in the face of commercial pressure and competition with other contractors. The ability to agree terms which can have the effect of frustrating the aims of the legislation, could be seen as "loop-holes". Though guidance could raise awareness of these it could not, in effect, close them. These issues relate to agreements on:

- the use of a trustee stakeholder accounts in which to suspend an adjudicator's award pending litigation or arbitration;
- final and conclusive decisions relating only to interim payments;
- cross contract set-off other than in certain circumstances;
- the use of pay-when certified type arrangements other than in certain circumstances;
- "pay when paid" clauses for cases of insolvency;

In the case of each of these examples, this consultation will consider carefully:

- how prevalent these clauses are and the extent of consensus in the industry that they should be addressed by the legislation we are proposing;
- how commonly such clauses are invoked;
- the extent to which the fact that they could be invoked affects the contracting process;
- the likely extent to which the use of guidance, as an alternative to legislation, would prevent parties from agreeing such clauses.

### **2. Addressing other issues raised by Sir Michael Latham's review**

It is less clear how guidance could be used in relation to the other half of the issues raised by Sir Michael's review.

- the proposal to clarify the meaning of an "adequate mechanism" for payment could be taken forward through guidance, assuming that no change in the law is considered necessary following consultation, and that clarification is all that is needed. However guidance would be unlikely to provide the necessary alternative to legislation alongside the legislative removal of Section 110(2). The review group was clear that the adequate mechanism should be expanded upon in legislation where Section 110(2) was removed.
- The issue related to Section 110(2) is unsuitable for guidance. The most obvious difficulty with the Section is that there is no sanction imposed on payers who choose to ignore the requirement to serve payment notices. Guidance could not address this problem. It could only offer advice to payees on how the legislation applies given that it is quite possible for payers to ignore the requirement.
- Guidance would also be unable to do more than advise contractors on an application for payment, it could not give the application statutory force as is proposed.
- If no legislative step is taken over the adjudicator's susceptibility to claims from third parties, guidance could raise the issue to make adjudicators aware. However, this would not alter the law to address the problem as the review group proposed, leaving adjudicators, in theory, susceptible to these kinds of action.
- Though guidance could enable adjudicators to make better decisions as to their jurisdiction, it could not alter the legal effect of the decision as the review group proposed. At present, though in practice, adjudicators do make decisions as to their jurisdiction, these can be challenged in enforcement proceedings, something the review group considered preventing in relation to certain specific issues. The issue discussed by the review group was one of the extent to which adjudicators should be able to make binding decisions as to their jurisdiction.

### Costs of guidance aimed at:

**Raising awareness of the problems caused by agreeing undesirable contract terms** – there is a cost to contractors in terms of potential loss of business if they attempt to refuse these undesirable terms. Guidance could be limited in its effectiveness for this reason.

Guidance would also have the unintended consequence of raising awareness of terms that have the effect of frustrating the legislation. By raising awareness, we may actually encourage use of these terms. It will be necessary for the consultation to establish a projection of the overall cost to the industry if the existing "loopholes" in the use of the legislation were more widely used.

- **Greater awareness of the potential for third party actions against adjudicators** – this could not prevent such actions from being brought and may even raise their incidence and the cost of adjudication as more adjudicators incur, then pass on, the cost of professional indemnity insurance. It will be necessary to evaluate these costs in the light of this consultation;
- **Advice and clarification (so far as is possible) of what an adequate mechanism should consist of under the current law, with Section 110(2) still in place** – as already stated this could have the effect of raising awareness of the limitations on a payee's ability to address a payer's failure to serve the necessary notice. This problem is expected to raise costs in the industry as more contractors become aware (and possibly take advantage) of the difficulties created by the issue. It will be necessary to evaluate this cost through the consultation by establishing the extent to which costs are currently effected by failure to submit Section 110(2) notices. Guidance on what should constitute an adequate mechanism would not prevent this abuse and may encourage exploitation of the loophole.
- **Allowing more informed non-binding decisions by adjudicators on their jurisdiction** – the significant cost here is that of challenges to jurisdiction. It will be necessary to evaluate this cost through the consultation. Though better decisions would be less susceptible to challenge under the present arrangements, challenges could not be prevented by guidance as the Latham working group envisaged.

### **Appendix 2 – Issues related to the potential use of a Regulatory Reform Order**

Given the Department's intention that the package being proposed could potentially be introduced through a Regulatory Reform Order, if possible we are also keen to ensure that:

- Measures within the package that apply regulatory burdens should do so in a way that is proportionate to the benefit realised as a result of the improvement made;
- The package as a whole might should strike a fair balance between the benefits realised overall and the new burdens affecting specific groups;
- That an RRO is desirable given the extent to which it would relieve the overall burden of the legislation in terms of relieving regulatory burdens and improving it more generally.

These tests must be passed if the package is to be acceptable for introduction through a Regulatory Reform Order, but they also provide a useful route to identifying the regulatory impact of the measures irrespective of how they might eventually be introduced. This means that in the final Regulatory Impact Assessment will need to evaluate for each measure:

- the regulatory impact of each new burden being applied;
- the benefits of the improvements that are made;
- whether these are proportionate;

and for the package as a whole:

- what the overall benefit is, taking account of the benefits and regulatory impacts;
- whether there is a fair balance between this and the burdens experienced by the most affected groups;
- whether an RRO could be considered desirable given the burdens being relieved and improvements being made overall.

# Annex 2 – Proposals that emerged from Sir Michael Latham’s review and that are not subject to formal consultation as part of this exercise

Sir Michael Latham's review raised issues and made proposals in several areas that we do not intend to consider as part of this consultation exercise although we would be interested in comments on the importance and appropriateness of these proposals if respondents wish to make them.

There are three main areas where we are not proposing to consult:

- Issues previously consulted on in "Improving Adjudication in the Construction Industry"
- Proposals to legislate only to provide clarification of the existing law as established by the courts
- Proposals to legislate to introduce measures for construction contracts affecting the framework of other late payment or insolvency legislation relating to all industry sectors.

We are also not consulting on:

- Amending the meaning 'of evidenced in writing'.
- Amending the scope.

## **Issues previously consulted on in "Improving Adjudication in the Construction Industry"**

### **Primary legislative amendments**

- Introducing a single adjudication procedure for all adjudications

### **Secondary legislative amendments**

- Requiring the adjudicator to give reasons for his decision unless requested not to
- Expressly providing a right to respond to a referral to adjudication
- Expressly providing a slip rule on the face of the Scheme for Construction Contracts
- Removing paragraphs 23(1) and 24 on enforcement

Following legal advice, the consultation exercise on "Improving Adjudication in the Construction Industry" concluded that guidance would be the best way forward on many of the issues that were raised. Though Sir Michael Latham's review did make a number of new proposals to address some of those issues, it did not present any new evidence that the issues raised required renewed attention. The one legislative proposal considered in "Improving Adjudication in the Construction Industry" which we are committed to implementing relates to the costs of the adjudication process. We would look to implement this proposal along with the findings of this review.

## **Proposals to legislate only to provide clarification of the existing law as established by the courts**

### **Primary legislative amendments**

- Clarifying the right to refer disputes under the contract to expressly allow claims for damages

### **Secondary legislative amendments**

- Expressly providing the adjudicator with the right to rule on the timing of the notice of referral to adjudication
- Requiring the adjudicator to share with the parties any legal or technical expert advice he receives
- Making specific provision for the adjudicator to evaluate and advise the parties of any entitlement to interest on late payments under the Late Payment of Commercial Debts (Interest) Act 1998
- Removing the requirement in Paragraph 8 of Part 1 of the Scheme restricting the referral of multiple disputes to adjudicators

Our legal advice has made clear that it would not be appropriate for the Government to legislate only to have the effect of clarifying the existing law as established by the courts. There may well be a role for guidance in raising awareness of the courts' interpretation of these areas of the legislation.

## **Proposals to legislate to introduce measures for construction contracts affecting the framework of other late payment or insolvency legislation relating to all industry sectors.**

### **Primary legislative amendments**

- Providing a statutory limit on the length of payment periods under construction contracts
- Providing payers under construction contracts with the right to redirect payments due to insolvent contractors to their creditors for construction work they have done under subcontracts on the project

It would not be appropriate for us to use the Construction Act to treat construction as a special case where there is other legislation, covering all industry sectors, which does not treat construction as a special case. We are satisfied that there is no case to consider implementing proposals that have the effect of making construction a special case in the context of wider payment or insolvency law. Detailed discussion of these specific proposals is set out in the following paragraphs.

**Providing a statutory limit on the length of payment periods under construction contracts** – The Payment Working Group discussed the possibility that payment periods under construction contracts could be limited by a "long stop" period in the Construction Act. This would regulate payment in the construction industry in a way in which it is not regulated elsewhere.

The Government consulted widely within the business community on the issue of payment times before introducing The Late Payment of Commercial Debts (Interest) Act. Respondents to the consultation made it clear that business parties must have the contractual freedom to agree their own payment periods recognising that there are significant variations across sectors and the cash flow requirements of businesses will differ. The Construction Act does, however, stipulate that where no credit period is agreed a default period of 30 days will apply, after which interest can run. This default credit period does not constitute a statutory credit period and the principal debt will still become due from the moment the goods are delivered or the service performed.

To prevent purchasers abusing the right to agree their own arrangements with the supplier, any such contractual remedy must be "substantial" otherwise it will be void and the debtor will be unable to rely on it. It will be struck down by the courts and the terms of the late payment legislation will apply to the contract. A contractual term may be void if it:

- confers a contractual right to interest that is not a substantial remedy for late payment of the debt; or
- varies the right to statutory interest so as to provide for a right to statutory interest that is not a substantial remedy for late payment of the debt.

Examples of contract terms which a court might declare void, to the extent that they relate to late payment because they result in there being no substantial remedy for late payment, might include:

- a credit period that is significantly different from custom and practice in that industry;
- a credit period that is significantly different from other supply contracts operated by the purchaser;
- an interest rate on late payment, significantly lower than the statutory rate, that fails to act as a deterrent to the purchaser paying late because it is lower than the purchaser's theoretical (or actual) cost of borrowing;
- an interest rate on late payment, significantly lower than the statutory rate, that fails to recompense the supplier for being kept from their money, because it is below the supplier's theoretical (or actual) cost of agreed borrowing;
- an interest rate on late payment significantly lower than the rate used in other supply contracts operated by the purchaser or than is normal in that sector of the economy;
- a contract term that has the effect of reducing the amount of interest that can be claimed, such that the compensation for late payment is insufficient to recompense the supplier or to act as a deterrent to late payment;
- excessive information requirements that must be fulfilled under the contract before any credit period might start.

The above list is not exhaustive and might not necessarily apply in every case. However, it must be stressed that the courts will look at the issue of a substantial remedy for late payment on a case by case basis.

The Government also recognised that more needed to be done to improve the UK's payment culture and introduced a number of other measures to promote a better payment culture including:

- Working with the Federation of Small Businesses to publish a league table of the average total payment times (including contractual payment period) of the UK's PLCs and their large subsidiaries. The League Tables enable smaller suppliers to identify the payment practice of these larger companies and make sectoral comparisons.
- Support for the Better Payment Practice Group to promote the economic benefits of prompt payment and to provide practical help to enable small businesses to manage credit more effectively.

**Providing payers under construction contracts with the right to redirect payments due to insolvent contractors to their creditors for construction work they have done under subcontracts on the project** – Where an insolvency office holder is required to realise and distribute the assets of an insolvent supplier under a construction contract, he must realise all of those assets, including money owed to the supplier, and distribute the proceeds amongst the creditors according to a set order of priority.

Contractors to an insolvent party (who would generally be among the unsecured creditors) have to be treated equally with all the other unsecured creditors. If the insolvent supplier has paid one creditor in preference to another when insolvent, then a liquidator can seek to recover the money from that creditor so that the funds are available to the whole body of creditors. To divert money, due under a contract with an insolvent supplier, to a particular creditor of the supplier, rather than making it available to be shared amongst all of the creditors therefore runs against core principles of insolvency law.

The only preferential treatment in insolvency cases is in respect of certain amounts due to employees. The Enterprise Act 2003 abolished the Crown's status as a preferential creditor. In doing this, the Government has taken a big step towards encouraging enterprise. It is estimated by the Revenue Departments that the abolition will free up approximately £70 million a year for the benefit of other creditors. These creditors can include many small businesses who would otherwise be at the end of the queue for payment and for whom there could be nothing left after the costs and secured creditors have been paid.

The current arrangements allow for the sharing of the risk of insolvency across all the insolvent parties' contracts. In any event, it is not clear that allowing some parties preferential treatment would be of any more general benefit to the UK economy as a whole. The Working Group claimed it would facilitate the completion of the payer's project. In fact this would be at the expense of the insolvent party's other creditors. Though the Working Group suggested these special arrangements could be justified in the construction industry it is not clear why the completion of a construction project is a greater priority than the completion of a contract to supply any other service to an insolvent supplier.

The Enterprise Act also introduced changes to insolvency legislation to make the administration procedure faster, fairer and focussed on rescue. The policy behind the changes is to encourage more companies that get into financial difficulties to seek help at an earlier point and thereby seeks to avoid viable companies going to the wall unnecessarily. If companies and their businesses can be rescued rather than being wound up then the outcome will be better for the company, its creditors and the economy as a whole.

### **Amending the meaning of "evidenced in writing" in Section 107 of the Housing Grants, Construction and Regeneration Act to allow the legislation to apply to contracts where there is only evidence of the existence of an agreement**

The Court of Appeal decision in *RJT Consulting v DM Engineering* [2002] is reported to have created concern that certain contracts, not all of whose terms are evidenced in writing, will not be subject to the legislation. That case concerned an oral contract which was subsequently disputed. The crux of the appeal court ruling was that a 28-day dispute resolution procedure could not be used to resolve disputes under a contract whose terms themselves were uncertain, as is often the case where terms have only been agreed orally. It took this view because of the need for a high degree of certainty of terms when dealing with an adjudication process under a demanding timetable.

The Court of Appeal therefore decided that the contract could only be evidenced in writing for the purposes of Section 107 if all its terms were so evidenced and not when some terms were disputed between the parties. It rejected as too weak the alternative interpretation of the Construction Act (and the one supported by the review group) in which it could be deemed to apply to all contracts whose general existence was evidenced in writing.

We accept the Court of Appeal's interpretation as being appropriate in the context of adjudication. It is essential that the adjudicator can identify easily the terms agreed between the parties. Time spent arguing over such terms would wholly undermine the intention of this statutory adjudication process.

The decision does not require the written contract to contain all of the terms required for compliance with the Construction Act as, where it does not comply, the Scheme for Construction Contracts is deemed to apply. The case also recognises the need for adjudicators to be robust in excluding trivial matters from what they need to consider as constituting the agreement that must be evidenced in writing. However it does require that for a contract to be capable of being referred to statutory adjudication, it must be possible to identify in writing those terms that have been agreed between the parties.

### **Amending the scope of application of the legislation through a revised Exclusion Order (rejection announced October 2004)**

- **Removing the exclusion of head contracts under the Private Finance Initiative** – It seems inappropriate to apply what is effectively a commercial alternative dispute resolution process to domestic customers. This would represent an unwanted shift in balance away from the customer and towards the industry.
- **Removing the exclusion of contracts for work on residential buildings with owner occupiers** – A PFI contract is far removed from a traditional, adversarial construction contract. Its duration requires a detailed alternative dispute resolution mechanism in any respect and we are not aware of any fundamental weakness in the general operation of these contracts.
- **Revising the exclusion of certain contracts for operations related process plant** – There are a number of differences between the process plant and construction industries. There have been cases at the intersection between the two where this exclusion has required practical interpretation by the courts but this in itself does not justify a change in the law. A better solution would be for the industry to issue guidance on the implications of the case law that has emerged.

# Annex 3 – Cabinet Office consultation code of practice

## **The six consultation criteria**

1. Consult widely throughout the process, allowing a minimum of 12 weeks for written consultation at least once during the development of the policy.
2. Be clear about what your proposals are, who may be affected, what questions are being asked and the timescale for responses.
3. Ensure that your consultation is clear, concise and widely accessible.
4. Give feedback regarding the responses received and how the consultation process influenced the policy.
5. Monitor your department's effectiveness at consultation, including through the use of a designated consultation co-ordinator.
6. Ensure your consultation follows better regulation best practice, including carrying out a Regulatory Impact Assessment if appropriate.

**The complete code is available on the Cabinet Office website at:**

[www.cabinetoffice.gov.uk/regulation/consultation/code.asp](http://www.cabinetoffice.gov.uk/regulation/consultation/code.asp)

# Annex 4 – Consultation response form

The numbering of questions on this form corresponds to the numbers given to the questions in the sections they are drawn from in the main body of the consultation paper.

## Chapter I – Payment Framework

### 1. Defining the content of an adequate payment mechanism in Section 110(1) of the Construction Act

- Q1.1** Do you agree that the payment framework under the Construction Act would benefit from the inclusion of a definition of what should constitute an adequate mechanism for payment? **(Yes / No)**
- Q1.3** Do you agree that the adequate mechanism should be expressly required to include terms stating:
- a)** What amounts constitute the payment under the contract **(Yes / No);**
  - b)** When a payment is to be assessed under the contract **(Yes / No);**
  - c)** How are the amounts to be determined **(Yes / No);**
  - d)** The period of time that should elapse from the point of assessment of the payment is to be ascertained before the final date for payment **(Yes / No);**
  - e)** What information is to be communicated between the parties (who provides what, to whom and in what level of detail during the process) **(Yes / No).**

Please explain the reasons for your answers.

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**Q1.6** Assuming that the requirement for an adequate mechanism in the Construction Act were included as proposed, do you agree that the mechanism in the Scheme for Construction Contracts satisfies all of the requirements of the payment mechanism as proposed? **(Yes / No – please explain what changes you believe would be needed)**

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**Regulatory impact**

**Q1(i)** What burdens / benefits do you believe will result from the redefinition of an adequate mechanism as proposed?

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## 2. Removing the requirement to serve a Section 110(2) notice in the Construction Act

**Q2.2** Do you agree that the requirement in Section 110(2) should be removed and that in its place the legislation should clearly define what is meant by "an adequate mechanism for determining what payments become due under the contract, and when"? **(Yes / No – please give reasons)**

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**Q2.3** If we remove this requirement, do you agree that at the same time the concept of a "due date" should be removed from the legislation in favour of, for instance, an "assessment date"? **(Yes / No)**

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**Q2.5** If the requirement for a payment notice in Section 110(2) were to be removed, do you agree that the requirement for a payment notice in Paragraph 9 of Part II of the Scheme for Construction Contracts should be retained as a fallback payment mechanism for cases where the mechanism in the contract proves inadequate? **(Yes / No – please explain)**

### **Regulatory impact**

**Q2(i)** If you believe that the requirement for Section 110(2) notices should be dropped would this offset any burden resulting from the proposed change to Section 110(1) **(Yes / No)**

**Q2(ii)** What would you estimate to be the financial cost of serving a Section 110(2) notice? **(£ per payment)**

**Q2(iii)** How frequently do you believe Section 110(2) notices are served under construction contracts?

- a) For 95 – 100% of payments?
- b) For 75 – 95% of payments?
- c) For 50 – 75% of payments?
- d) For 25 – 50% of payments?
- e) For 5 – 25% of payments?
- f) For 0 – 5% of payments?

**Q2(iv)** How often do you believe a payment dispute arises in part due to a payer's failure to serve payment notice under Section 110(2) of the Construction Act and / or the misunderstanding that there is a legal entitlement to payment of the amount in the notice if it is served?

- a) As a result more than one in 10 failures to serve a payment notice.
- b) As a result of between one in 10 and one in 100 failures.
- c) As a result of fewer than one in 100 failures to serve a payment notice.

### 3. Providing an application for payment in the legislation

**Q3.1** Do you believe that an application should be available for a payee to submit...

- a) as of right when necessary  
(as in our suggested proposal)?
- b) as a requirement of a contract that  
complies with the Construction Act?
- c) where the contract does not contain  
any provision for an application?
- d) other (please specify)?
- e) not at all?

**Q3.5** Do you believe the payer should have:

- a) no right of response  
to the application?
- b) a general right of response  
to the application?
- c) a specified right of response  
with requirements as to content  
and / or timing of the response  
(please specify)?
- d) Other – please specify?

**Q3.6** Do you believe that the amount applied for should become payable by the  
specified final date for payment under the legislation ?

- a) No (as in our proposal)
- b) Yes – but only if the payer has not  
responded to the application
- c) Yes – though only to the extent  
considered appropriate by an  
adjudicator, arbitrator or court  
in certain circumstances
- d) Yes – but only to the extent agreed  
by the payer (leaving adjudication  
etc to settle any disputes)
- e) Yes – under the legislation as  
an automatic requirement in  
certain circumstances?  
If so, which circumstances
- f) Yes – other (please specify)

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**Regulatory Impact**

**Q3(i)** What do you believe is likely to be the administrative cost of a) issuing an application under the legislation as proposed and b) receiving such an application? How would this compare to current costs? **(please specify your answer in £ per payment)**

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**Q3(iii)** Which one of the following do you think would be the most likely way in which the right of application proposed in section 3 would be used?

- a) In response to the large majority of payment transactions under the existing legislation or the proposed "adequate mechanism".
- b) When the payee is unhappy with the amount proposed to be paid.
- c) When the payee believes the contractual payment mechanism has failed and an amount should have been ascertained.
- d) At the conclusion of the withholding period under Section 111 of the Construction Act when the payee is unhappy with the amount proposed to be withheld and / or paid.
- e) When the payee believes he has not received the payment due by the final date for payment under the contract.
- f) Other – please specify.

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**Q3(iv)** Given your answer above, how frequently do you believe the right of application would be exercised under our proposal?

- a) For 95 – 100% of payments.
- b) For 75 – 95% of payments.
- c) For 50 – 75% of payments.
- d) For 25 – 50% of payments.
- e) For 5 – 25% of payments.
- f) For 0 – 5% of payments.

**Q3(v)** Do you believe the number and complexity of disputes in the construction industry would be likely to increase or decrease by issuing an application under our proposal? Please indicate your reasons.

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#### 4. Redefining the content of withholding notices under Section 111

**Q4.2** Do you agree that, following the removal of Section 110(2) and the inclusion of a definition of an "adequate mechanism" in Section 110(1), Section 111 should include a requirement to state the amount the paying party intends to pay as well as the amount(s) to be withheld? **(Yes / No)**

**Q4.3** Do you agree that it would not be appropriate to amend the legislation to include a description of what would represent "sufficient detail" when giving grounds for withholding payment in a Section 111 notice? **(Yes / No)**

##### **Regulatory impact**

**Q4(i)** Do you agree with our assessment that there is only a negligible cost to the payer of stating the payment he now intends to make when issuing a withholding notice? **(Yes / No)**

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## 5. Restricting the use of pay-when-certified clauses

**Q5.4** Do you agree that where a "pay-when-certified" arrangement is provided in a contract...

- a) ...the contract should identify the element of the works in the certificate, of which the subcontract work forms a part and when the certificate will become due under the main contract for the element in question? **(Yes / No)**
- b) ...the contract should require that a copy of the certificate is passed to the subcontractor within five days of the ascertainment date? **(Yes / No)**
- c) ...other – please specify.

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**Q5.5** Furthermore, do you agree that where the amount to be paid under the subcontract is to be determined by the certificate under the main contract (a "pay-what-certified" arrangement), the subcontract should...

- a) ...provide that the work will be priced individually in the certificate as part of the package of work it covers? **(Yes / No)**
- b) ...describe how the payment due under the subcontract will be ascertained based upon the price in the certificate? **(Yes / No)**
- c) ...other – please specify.

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**Q5.6** Do you believe that the proposal is appropriate for "management contracting" arrangements where they involve pay-when-certified clauses? **(Yes / No – please give reasons)**

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**Q5.7** Do you believe that the proposal is appropriate for contracts with "nominated subcontractors" where they involve pay-when-certified clauses? **(Yes / No – please give reasons)**

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**Regulatory impact**

**Q5(i)** What proportion of subcontracts do you believe contain "pay-when-certified" clauses for one or more payment stages?

- a) For 95 – 100% of subcontracts.
- b) For 75 – 95% of subcontracts.
- c) For 50 – 75% of subcontracts.
- d) For 25 – 50% of subcontracts.
- e) For 5 – 25% of subcontracts.
- f) For 0 – 5% of subcontracts.

**Q5(ii)** What proportion of contracts do you believe contain "pay-what-certified" clauses for one or more payment stages? **(answer using list (a) – (g) in the question above)**

**Q5(iii)** How often do you believe a payment dispute arises in part due to the inclusion of a "pay-when-certified" or "pay-what-certified" clause?

- a) As a result more than one in 10 clauses in contracts.
- b) As a result of between one in 10 and one in 100 clauses in contracts.
- c) As a result of fewer than one in 100 clauses in contacts.

## Chapter II – Other payment proposals

### 6. Introducing a right to reimbursement for the costs of suspension and remobilisation and providing additional time for remobilisation under Section 112 of the Construction Act

**Q6.1** Do you agree that it is necessary to supplement the right to suspend performance under the contract? (**Yes / No**) If so, please explain the impact of the current deficiencies in the legislation (in terms of cost, time, disputes etc.).

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**Q6.2** Do you believe that an enhanced right of suspension should include:

**a) the right to recover the reasonable costs of suspension?**  
**(Yes / No – please explain)**

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**b) the right to recover the reasonable costs of remobilisation?**  
**(Yes / No – please explain)**

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**c) the right to require an appropriate delay in remobilisation?**  
**(Yes / No – please explain)**

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**d) other (please indicate what other rights would need to be included)**

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**Q6.3** Do you agree that the issue of what constitutes

- a) the reasonable costs of suspension;
- b) the reasonable costs of remobilisation;
- c) an adequate delay in remobilisation

is best dealt with as a matter of contract? **(Answer Yes / No for each of (a) – (c) as above)**

- a) (Yes / No)
- b) (Yes / No)
- c) (Yes / No)

**Q6.5** Do you believe the fallback provisions should ...

**a)** ...set the reasonable maximum cost of suspension and remobilisation at 5% of the value of the payment in default? If not, please indicate in what circumstances you believe this figure could be inappropriate and what alternative figure you believe would be more appropriate.

**b)** ...set the appropriate maximum delay in remobilisation at seven days? If not, please indicate in what circumstances you believe this figure could be inappropriate and what alternative figure you believe would be more appropriate.

**Regulatory impact**

**Q6(i)** How frequently in cases of defaulted payment do you believe the right to suspend performance under the contract is exercised:

- a) In more than one in 10 instances of defaulted payment;
- b) In between one in 10 and one in 100 instances of defaulted payments;
- c) In fewer than one in 100 instances of defaulted payment;

**Q6(ii)** Under the proposed change in the law, how frequently do you believe that the right of suspension will be exercised:

- a) In more than one in 10 instances of defaulted payment;
- b) In between one in 10 and one in 100 instances of defaulted payments
- c) In fewer than one in 100 instances of defaulted payment;

**Q6(iii)** What do you believe are the typical costs of suspension of performance? (£)

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**Q6(iv)** What do you consider to be the typical costs remobilisation? (£)

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## 7. Making contractual provisions on cross contract set-off ineffective

**Q7.1** Do you agree that the use of cross contract set-off clauses should be limited? Please explain what the costs / benefits to the industry of your recommended approach.

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**Q7.2** Do you believe that the common law definition of "equitable set-off" ("a close relationship exists between the dealings and transactions which gave rise to the respective claims") provides sufficient flexibility to meet the reasonable requirements of the construction industry? **(Yes / No)**

**Q7.3** Do you believe that cross-contract set-off should generally be permitted where the work is part of a series of projects under framework or similar agreements? **(Yes / No)**

**Q7.4** If yes, please explain which contracts / commercial arrangements would fall into this category which you believe would not be covered by the right of equitable set-off.

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## Regulatory impact

**Q7(i)** What is the cost to the industry of the use of set-off clauses? What would be the impact on these costs of the different options discussed in this section (limiting set-off to the common law definition, permitting set-off in defined contractual arrangements, allowing pre-agreement to specific set-off clauses)?

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**Q7(ii)** How often do you believe contracts contain cross-contract set-off clauses?

- a) In 95 – 100% of cases.
- b) In 75 – 95% of cases.
- c) In 50 – 75% of cases.
- d) In 25 – 50% of cases.
- e) In 5 – 25% of cases.
- f) In 0 – 5% of cases.

**Q7(iv)** Do you believe that invoking a cross contract set-off clause in a contract is likely to...

- a) ...cause or escalate a dispute between contracting parties?
- b) ...shift a dispute from one project to another project without resolving it?
- c) ... help to prevent or resolve a dispute between contracting parties?

## 8. Making "pay-when-paid" clauses ineffective in cases of "upstream" insolvency proceedings

**Q8.1** Do you believe it is beneficial to the industry to retain the ability to invoke "pay-when-paid" clauses in cases "upstream" insolvency proceedings? (**Yes / No – please explain**)

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**Q8.2** If you believe these provisions should be prohibited, please explain the costs benefits to the industry in comparison to the current position. Please explain the impacts on cash flow, risk etc within the supply chain with your proposed approach.

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### **Regulatory impact**

**Q8(i)** Do you believe that the removal of the ability to invoke "pay-when-paid" clauses in the case of upstream insolvency proceedings would result in fewer insolvencies elsewhere in the supply chain? If so, please indicate the cost / benefits to the industry, and to individual elements of the supply chain / clients of this change.

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**Q8(ii)** Alternatively, do you believe that the overall cost of insolvency to the supply chain would stay the same regardless of which option was chosen from those set out above? If so, please say why.

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**Q8(iii)** How frequently do you believe pay-when-paid-clauses are included in contracts?

- a) In 95 – 100% of contracts.
- b) In 75 – 95% of contracts.
- c) In 50 – 75% of contracts.
- d) In 25 – 50% of contracts.
- e) In 5 – 25% of contracts.
- f) In 0 – 5% of contracts.

**Q8(iv)** How frequently do you believe upstream insolvencies arise under construction contracts?

- a) In 95 – 100% of contracts.
- b) In 75 – 95% of contracts.
- c) In 50 – 75% of contracts.
- d) In 25 – 50% of contracts.
- e) In 5 – 25% of contracts.
- f) In 0 – 5% of contracts.

**Q8(v)** How frequently do you believe pay-when- paid clauses are invoked where they are included in construction contracts where an upstream insolvency occurs?

- a) More than half the time?
- b) About half the time?
- c) Less than half the time

What is the impact on companies and clients of this action?

## 9. Allowing stage payments under the Scheme for Construction Contracts to be made for materials in advance of their arrival on site

**Q9.1** Do you agree in principle that the Scheme for Construction Contracts should make provision for stage payments for materials held off-site and off-site work upon them if this is possible? **(Yes / No – please explain)**

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**Q9.2** If so, what conditions do you believe should apply for payment to be required for work off-site under the Scheme?

- a) That ownership for the materials paid for is substantiated as having transferred to the payee?
- b) That access will be provided to the payer, on demand, for inspection or collection?
- c) That a full refund for the value of the materials owned by the payer off-site will be available with the return of ownership to the payee?
- d) That a refund should also be available for any work done on the materials and components under Paragraph 2(2)(a) of Part II of the Scheme, once their ownership has transferred to the payer?
- e) That this refund should become available in cases where the work did not meet the original specification?

### Regulatory impact

**Q9(i)** How often on projects do you believe the payment framework in the Scheme for Construction Contracts is used (either by agreement or as a fallback adequate payment mechanism or fallback framework for stage payments)?

- a) In 95 – 100% of projects.
- b) In 75 – 95% of projects.
- c) In 50 – 75% of projects.
- d) In 25 – 50% of projects.
- e) In 5 – 25% of projects.
- f) In 0 – 5% of projects.

**Q9(ii)** How often do you believe projects include work on materials held off-site for delivery to site at a later stage (irrespective of whether stage payments are provided)? (answer (a) – (f) above)

- a) In 95 – 100% of projects.
- b) In 75 – 95% of projects.
- c) In 50 – 75% of projects.
- d) In 25 – 50% of projects.
- e) In 5 – 25% of projects.
- f) In 0 – 5% of projects.

## Chapter III – Adjudication proposals

### 10. Preventing the use of "trustee stakeholder accounts" to suspend an adjudicator's award pending litigation other than when the recipient is involved in insolvency proceedings.

**Q10.1** Is the current use of trustee stakeholder accounts appropriate? What is the impact on the industry (positive or negative)?

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**Q10.2** If you think the current practice is not appropriate, how do you think the legislation should be amended to improve cash flow and the effectiveness of the adjudication process? Should we include:

- a)** a provision in the Act to make unenforceable contractual provisions requiring the payment of an award into a trustee stakeholder account? .
- b)** a power for the adjudicator to overrule any contractual provision requiring the payment of his award into a trustee stakeholder account?.
- c)** a broader power for the adjudicator to overrule any contractual requirement for payment at all to be made into a trustee stakeholder account (not simply the adjudication award)?.
- d)** a broader power for the adjudicator to overrule any contractual requirement at all which has the effect of delaying the effect of his decision?.
- e)** Other – please specify.

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**Q10.3** Do you believe that the adjudicator should be allowed to make his award into a trustee stakeholder account in cases where the receiving party is subject to insolvency proceedings. If so, should this be possible:

- a) under all adjudications by including a requirement in the Construction Act?
- b) under all adjudications under the Construction Act as the only means of obtaining a stay in the adjudicator's decision?
- c) only in adjudications under the Scheme and in cases where the parties have agreed to the use of a trustee stakeholder account for adjudicators award (as we have proposed)?
- d) Other (please explain)?

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Alternatively, do you believe that:

- e) stays in an adjudicator's decision should only be available through the courts?
- f) stays in adjudicator's decisions should not be available at all?

**Regulatory impact**

**Q10(i)** What would be the cost / benefit to your business and your projects of permitting the use trustee stakeholder accounts for adjudication awards in cases where the receiving party is insolvent, or will become insolvent before the dispute is finally decided?

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**Q10(ii)** How often do you believe construction contracts contain clauses requiring adjudicator's decisions be paid into trustee stakeholder accounts?

- a) More than one contract in 10?
- b) Between one contract in 10 and one in 100?
- c) Fewer than one contract in 100?

How do you think this would change if the legislation were amended and what would be the impact (cost and risk) on companies in the supply chain?

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**Q10(iii)** How often do you believe these clauses result in a party deciding against referring a dispute to adjudication where it would otherwise have been referred?

- a) More than half of disputes?
- b) About half of disputes?
- c) Fewer than half of disputes?

What is the cost / benefit to the industry and to delivery of projects of this practice?

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**Q10(iv)** How often do you believe an award is made at adjudication where the receiving party is in insolvency proceedings?

- a) More than one adjudication in 10?
- b) Between one adjudication in 10 and one in 100?
- c) Fewer than one adjudication in 100?

**11. Providing the adjudicator with the power to rule on certain aspects of his own jurisdiction and providing a right to payment in cases where the adjudicator stands down due to lack of jurisdiction.**

- Q11.1** Do you believe an adjudicator should have...
- a) ...no power to make a final and binding decision of his jurisdiction?.
  - b) ...power to make a final and binding decision of his jurisdiction only in certain areas?.
  - c) ...power to make a final and binding decision of his jurisdiction in any area?
- Q11.2** Do you agree with the principle that an adjudicator should only have the responsibility to make binding decisions in response to jurisdictional challenges in areas where there can be confidence in his ability to make a correct and reliable decision? **(Yes / No)**
- Q11.3** If you agree with the principle in Q11.2, do you agree that adjudicators could be expected to make correct and reliable decisions on the following grounds:
- a)...whether there is a construction contract for the purposes of Sections 104 and 105 of the Act? **(Yes / No)**
  - b)...whether there is a dispute? **(Yes / No)**
  - c)...whether the adjudicator was properly appointed? **(Yes / No)**
- Q11.6** Do you believe that the legislation should provide the adjudicator with a statutory right to payment in any of the following circumstances:
- a) when standing down after deciding he does not have jurisdiction?.
  - b) when standing down after making a binding decision that he does not have jurisdiction under the proposal?.
  - c) when standing down with the agreement of both parties to the contract (as at present)?.

## Regulatory Impact

**Q11(i)** How often do you believe adjudicators make non-binding decisions as to their jurisdiction?

- a) In 95 – 100% of adjudications.
- b) In 75 – 95% of adjudications.
- c) In 50 – 75% of adjudications.
- d) In 25 – 50% of adjudications.
- e) In 5 – 25% of adjudications.
- f) In 0 – 5% of adjudications.

**Q11(ii)** How often do you believe a jurisdictional challenge relates largely to:

- whether there is a construction contract for the purposes of Sections 104 and 105 of the Construction Act;
- whether there is a dispute; and,
- whether the adjudicator was properly appointed;
  - a) More than half of jurisdictional challenges;
  - b) About half of jurisdictional challenges;
  - c) Fewer than half of jurisdictional challenges;

**Q11(vi)** What do you believe to be the average total cost of enforcement proceedings to the parties? (£)

## 12. Providing the adjudicator with the right to overturn "final and conclusive" decisions where these are of substance to interim payments only

**Q12.1** What, if any, benefits arise from the use of "final and conclusive" decisions for interim payments?

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**Q12.2** Do you agree that unless a decision is of substance to a non-interim payment, the interim payment resulting from an adjudicator's decision could be revised in a subsequent payment or in the final account? Are there any circumstances in which this might not be the case? If so, is there a mechanism by which this could be addressed within the proposal?

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**Q12.3** Do you agree that the legislation should...

- a)** ...allow adjudicators in all adjudications to open up decisions or certificates which are of substance to interim payments; or,
- b)** ... leave the matter to the contract between the parties as at present with the current provision in the Scheme allowing the adjudicator to open up only decisions and certificates that are not final and conclusive?

Please explain your answers.

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## Regulatory impact

**Q12(i)** How often do you believe contracts include clauses making decisions or certificates "final and conclusive" of matters that are only of substance to interim payments?

- a) In 95 – 100% of contracts.
- b) In 75 – 95% of contracts.
- c) In 50 – 75% of contracts.
- d) In 25 – 50% of contracts.
- e) In 5 – 25% of contracts.
- f) In 0 – 5% of contracts.

### 13. Extending the adjudicator's immunity under the Construction Act to claims by third parties

**Q13.1** Do you agree that the adjudicator should be provided with statutory immunity, as is provided to arbitrators by Section 29 of the Arbitration Act 1996 in place of the current requirement for contractual immunity in Section 108(4)? of the Construction Act **(Yes / No)**

**Q13.2** Are you aware of instances where the possibility of a third party claim against an adjudicator has had an adverse effect on the adjudication? **(Please give details)**

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#### Regulatory impact

**Q13(i)** How often do you believe an adjudication results in a real possibility that an action could be brought by a third party (irrespective of whether such an action is brought)?

- a) In 95 – 100% of adjudications.
- b) In 75 – 95% of adjudications.
- c) In 50 – 75% of adjudications.
- d) In 25 – 50% of adjudications.
- e) In 5 – 25% of adjudications.
- f) In 0 – 5% of adjudications.

**14. Applying provisions on adjudicator independence from the Scheme for Construction Contracts' to all adjudications in Section 108 of the Construction Act**

**Q14.1** Do you agree with the proposed amendment to replicate the Scheme test of independence in the Construction Act?

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**Regulatory impact**

**Q14(i)** How often do you believe adjudications are conducted where the adjudicator would fail the requirement for independence in the Scheme for Construction Contracts?

- a) In 95 – 100% of contractual adjudications.
- b) In 75 – 95% of contractual adjudications.
- c) In 50 – 75% of contractual adjudications.
- d) In 25 – 50% of contractual adjudications.
- e) In 5 – 25% of contractual adjudications.
- f) In 0 – 5% of contractual adjudications.







