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CONSTRUCTION ACT REVIEW THE DTI'S PROPOSALS FOR AN ADEQUATE PAYMENT MECHANISM

Background

In January 2006 the Department of Trade and Industry and the Welsh Assembly Government issued an analysis of the responses to their 2005 consultation on proposals to amend Part II of the Housing Grants, Construction and Regeneration Act 1996 and the Scheme for Construction Contracts (England and Wales) Regulations 1998. They also made a number of proposals for amending the Act - better known as the Construction Act.

An electronic version of the document can be found at:

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

This Briefing considers the DTI's key proposal on defining an "adequate mechanism" for payment.

The DTI's Proposal

1. The DTI proposes to amend s.110(1) to provide for a contractual adequate payment mechanism that conforms with certain statutory requirements.
2. S.110 would require that the contractual mechanism provides for a statement of what is due in a certificate.
3. Such certificate could be issued by:
 - a. the payer,
 - b. the payee or;
 - c. a third party named in the contract.

Continued overleaf



4. Where a certificate is not issued (presumably by the payer or the named third party certifier) the payee would have a right to issue an application stating the sum due.
5. The DTI states that its mechanism will define the sum due for the purposes of s.111 (withholding notices) and s.112 (right of suspension).
6. If the payee has to exercise his statutory right to apply for payment stating the sum due the date of application will be the due date (presumably the date of a payer's certificate or a third party's certificate will also be the due date).
7. Where there is no certification process in the contract (meaning that the contract does not conform to the legislation) the Scheme will provide for an application for payment from the payee.

What is the current deficiency in the Act?

8. During the debate on the Construction Bill (as it then was) in the House of Lords in 1996, Lord Lucas (on behalf of the government) said that: "the [Construction Bill] requires that payment should be **defined** in terms of **amount** and **date**." (emphasis added)
9. The operation of two crucial provisions in the Act - the right of withholding and the right of suspension - are wholly dependent upon payment being defined in terms of amount and date.
10. S.110(1) requires that all contracts have "an adequate mechanism for determining what payments become due under the contract, and when..." Unfortunately the vast majority of contracts in the industry do not define the amount that has to be paid on the due date or even the due date itself (especially where there is a pay-when-certified arrangement in place).
11. With regard to defining the amount that has to be paid by the date for payment, most contracts do not contain any means for resolving the deadlock when A has asked for £X and B has responded with £Y.
12. Section 111(4) of the Act only anticipates adjudication being used when there is a dispute as a result of B withholding monies from A. The Act does not anticipate the use of adjudication as a means of defining the baseline figure from which a withholding is made.
13. This problem has already been touched upon in the Scottish case of Maxi Construction Management v. Morton Rolls Ltd., 2001 CILL, 1784. In that case the employer's agent was required to agree a valuation with the contractor before the latter submitted its application. There was no obligation upon the agent to reach agreement within a timescale. Lord MacFadyen in the Outer House of the Court of Session held that this provision was an inadequate mechanism. Continued overleaf

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The judge explained his decision as follows:

“Failure on the part of [the employer's agent] to agree a valuation could hold up the making of a claim for payment indefinitely... The absence of a timetable and of a **means for resolving deadlock**... renders inadequate the machinery for determining **when** payments are due.”
(emphasis added)

14. Furthermore, it was accepted by Counsel for the defender, Morton, that the lack of a means for resolving deadlocks also rendered inadequate the mechanism insofar as it related to what was payable.
15. Put simply, the mechanism can only be adequate if there is a means of dealing with the difference of view over the amount of A's application by the final date for payment. At present the only way of dealing with this is for the parties to go to adjudication; but adjudication should not be a part of the process of defining what is to be paid.

Will the DTI's proposals improve the current position?

16. As a general statement a statutory mechanism will always be more appropriate because:
 - a. the existing statutory provisions are dependent upon there being certainty of the amount/timing of payment and, therefore, such matters cannot be left to chance - there has to be such certainty for the Act to operate effectively.
 - b. the payee will always have to determine whether the mechanism was Act-compliant; in practice this could be a difficult, time-consuming and costly process for the vast majority of firms, many of whom have to regularly scrutinise voluminous contractual documentation.
17. At the DTI conference on 14 February 2006 the DTI acknowledged that the Construction Act provides a framework for achieving better payment practice. A statutory adequate payment mechanism would still be a framework within which parties would have freedom to put their own contractual touches on the mechanism. Such mechanism would not, for example, remove the freedom to determine how payments should be calculated.
18. Moving into specifics, it is unlikely that the DTI's proposals would improve the current situation. If the payer issues a certificate and the payer disagrees with the certificated amount, there is still no definition of what has to be paid by the due date for payment (assuming that the due date has been defined).

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19. On the other hand, if the certificate is not issued by the payer, it is unclear as to what happens in the event of the payer disagreeing with the amount submitted by the payee in the exercise of his statutory right to issue an application.
20. If a third party issues a certificate it would have to be clear that the amount represented by the certificate is the due sum. Certificates can be challenged by the employer.
21. The employer can refuse to pay a third party certificated amount where he has raised a bona fide argument or contention that the certificate may have been overvalued (see CM Pillings & Co -v- Kent Investments [1985] 30 BLR 84 and RM Douglas Construction -v- Bass Leisure [1991] 53 BLR 124). As an aside, if the Act were to require that all construction contracts should provide for an independent third party whose certificated amounts represented the due sums, this would be a solution (although it would be inappropriate for small contracts and for certain payment systems other than valuation).

Where do we go from here?

22. SEC Group has considered very carefully similar legislation in Australia, New Zealand and Singapore. Those responsible for drafting the legislation in these countries have been able to evaluate the experience of our own legislation and remedy the weaknesses. The New Zealand Construction Contracts Act (NZCCA) 2002 provides a workable solution.
23. The statutory mechanism in the NZCCA 2002 comprises:
 - a. An application for payment;
 - b. A response to the application;
 - c. A provision that states what constitutes the debt that has to be paid by the date for payment.
24. The Construction Act should, therefore, state that the debt will be either the application if there is no response to it, or the amount stated in the response (provided the response fully justifies any difference from the amount applied for)*. This solution would involve a redrafting of s.110 and s.111.

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*Concern has been expressed that an overstated or exaggerated application could become an enforceable debt. Since the application will primarily relate to progress payments the payer can re-adjust the position prior to the next payment becoming due. If the application relates to a final payment the payer can always defend any enforcement process by giving evidence that the application was overstated. In any event, by the final payment stage the parties are likely to have achieved a reconciliation of the outstanding account which would be reflected in the final application. Where there has been an exaggerated application coupled with dishonesty this will constitute fraud; fraud will be much easier to prosecute once the Fraud Bill becomes law.



SEC Group's Re-draft of Sections 110 and 111

- 110.(1) A party to a construction contract has the right to make an application for payment at any time specifying the amount claimed and the basis on which the amount was calculated.
- (2) The other party has the right to make a response to a payment application not later than 15 days after receipt of the application.
- (3) The response must specify:
- (a) the amount the party proposes to pay, and where the amount is different from that in the payment application;
 - (b) the reasons for the different amount; and
 - (c) the basis on which the amount was calculated, and where the reasons for the different amount refer to any claim for loss or damage arising from the other party's breach of his contractual obligations, the response must also specify -
 - (d) when the loss or damage was incurred,
 - (e) the items constituting such loss and damage, and
 - (f) the amount claimed in respect of each item.
- (4) Where the response includes a claim for loss or damage such claim must not relate to a contract other than the extant contract. Subsection (4) does not affect the operation of equitable set-off
- (5) Not later than 30 days after receipt of the payment application the paying party shall pay -
- (a) the amount in the payment application in the absence of a response complying with subsections (2), (3) and (4); or
 - (b) where a response complying with subsections (2), (3) and (4) is issued, the amount stated in that response.
- (6) Where a response complying with subsections (2), (3) and (4) is given, but on the matter being referred to adjudication it is decided that the whole or part of the difference in the amount between the application for payment and response should be paid, the decision shall constitute a debt requiring payment in full not later than seven days from the date of the decision.

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Conclusion

25. The DTI's proposals - to the extent that they have been articulated - do not constitute an adequate mechanism for determining what has to be paid and when. Rather than remedying the existing weaknesses in the legislation they will lead to a worsening of the current situation.
26. The above draft has the merit of simplicity and clarity. Above all else, it has certainty which would find favour with over 90% of firms in the industry.