EVERSHEDS SUTHERLAND

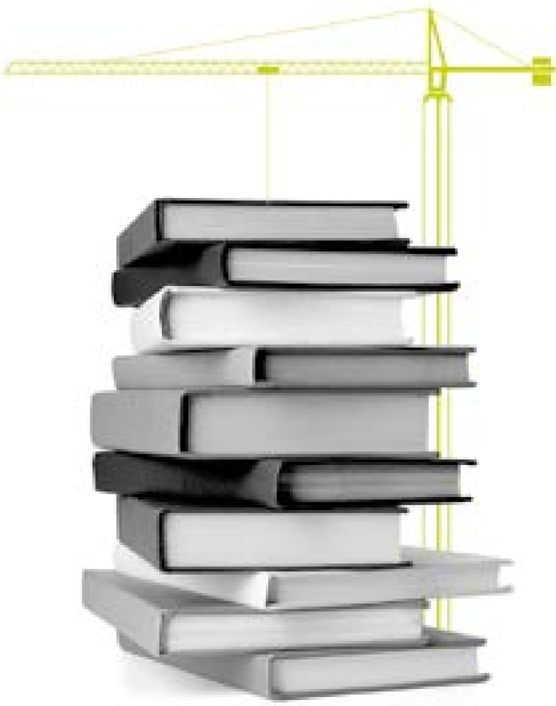
Construction

Summer 2019

Foundations

Taking your knowledge to new heights

Our construction update



Eversheds Sutherland Foundations

Welcome to Foundations, our construction and engineering monthly newsletter. Foundations will update you with details of what we think are the top three court cases decided in the previous month, a summary of important legislation changes or proposals, and a paper providing insight and guidance on a particular area of construction law and practice in the UK (UK insight).

We hope you find our newsletter useful and informative.

Contents

Including a review of these cases, and what to expect in 2019, this edition focuses on:

Please do contact any member of the team if you would like to discuss any of the content in this edition further.

Update on UK legislation

Accelerating Construction Payments, But Slowly

Despite the distractions of Brexit, the UK government still has the construction industry firmly within its sights.

Two items of proposed legislation (one new, one a change) look at the issue of cashflow – a perennial problem in a low-margin multi-layered sector such as construction. Our longer article page 14 considers the stalled progress of the new Aldous Bill which looks at retentions.

To tackle payment issues, which can be a barrier to sector investment, productivity and growth, the Department for Business, Energy & Industrial Strategy (BEIS) is consulting on further changes to the Construction Act (or more properly the Housing Grants, Construction and Regeneration Act 1996).

The Act was amended in 2011 (see our article on those changes) but has not been entirely successful in its aims of improving cashflow. BEIS issued a consultation in October 2017 called '2011 Changes to Part 2 of the Housing Grants, Construction and Regeneration Act 1996'. The consultation closed in January 2018 and focused on:

- Whether the Acts improved the clarity and transparency of the payment framework
- Bolstering rights to suspend carrying out works or services when payments are not made
- The efficacy and affordability of adjudication.

You can read more about the consultation and the parallel one on retentions in our UK insight at page 14. The consultation remains particularly relevant in the context of BEIS' focus on improving payment practices with regards to SMEs. There are over 1 million businesses in UK construction with less than 50 employees

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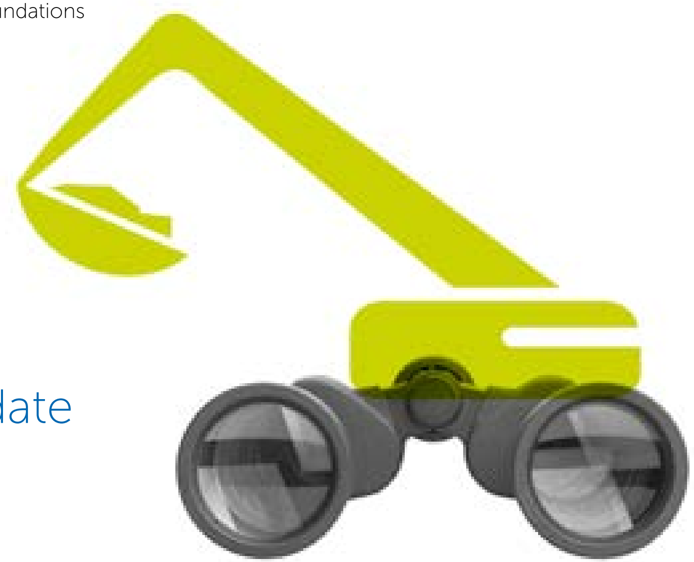
In December 2018, BEIS' committee censured the UK government for being slow to introduce a tougher regime, tackle persistent slow or late payment by larger companies. The committee's report recommended the introduction of a statutory 30-day payment requirement, and a requirement for all medium and large companies in construction to sign the Prompt Payment Code. It also suggested new powers for the Small Business Commissioner to fine companies who pay late.

These measures are no panacea to the troubles of payment in construction but watch this space.

For more information, please contact:

Richard Hartigan
Partner
T: +44 121 232 1525
richardhartigan@
eversheds-sutherland.com



UK case update

Follow the letter of the contract not just its spirit

Summary:

If your contract requires notice in writing or for a notice or claim to refer to the relevant contract provision then you must follow that procedure to the letter.

Background:

Construction and engineering contracts contain a variety of processes and mechanisms designed to allow the project to flex to accommodate new information, changing needs, site conditions, design development and outside events. But just how important is it to stick to those processes rigidly?

If, for example, the scope of the works needs changing, then construction and engineering contracts all include procedures (to varying degrees) to allow those changes to be instructed.

These change mechanisms require the parties and contract administrator to follow a set of steps to properly record the changes to the original contract data. the change being instructed and its impact on the cost of the works and the programme/completion dates.

But the devil, as always, is in the detail. NEC4 requires all communications to be be in a form which can be recorded – so email is acceptable but not a chat.

View our previous article here which confirmed that any constraints or requirements within a contract process must be followed to be effective. In Rock Advertising v MWB Business Exchange Centres a licence agreement clearly stated that any changes to the agreement had to be in writing and signed by both parties.

A telephone chat to change the payment schedule was not sufficient. This would also apply to verbal instructions under NEC4.

The process requirement of contracts has been further bolstered by a Hong Kong court decision (Maeda v Bauer Hong Kong) which said that if a claim or notice was required by the contract to refer to a specific provision then it must do so, and cannot be co-opted after the event as a notice for a separate claim. The relevant provisions were conditions precedent and, as the judge said had to be strictly complied with – if the processes were not followed then one party would lose its entitlements.

What this means for you

Each of the standard form construction or engineering contract suites varies in its approach to processes.

The JCT suite tends to take a less process-driven more flexible approach, with few (if any) of its processes acting as conditions precedent.

The NEC suite was originally drafted as process flowcharts and contains time bars and conditions precedent, as well as a requirement for all communications to be in writing and notified separately.

The FIDIC 2017 suite is even more prescriptive in terms of both supporting details required, the process and time bars on both parties and conditions precedent.

The lesson from these cases is to read and follow your contract to the letter if you want to preserve your remedies – whether as a client or as a contractor.

- Rock Advertising Ltd v MWB Business Exchange Centres Ltd [2018] UKSC 24
- Maeda Kensetsu Kogyo Kabushiki Kaishaalso known as Maeda Corporation Bauer Hong Kong Ltd [2019] HKCFI 916

For more information, please contact:

Ray Hetherington
Senior Associate
T: +44 121 232 1320
rayhetherington@
eversheds-sutherland.com

Dealing with the elephant in the room

Summary

Practical completion is often referred to as ‘easier to recognise than define’ (much like an elephant) with few hard and fast objective tests for construction contracts. A helping hand is now available for contract administrators tasked with balancing legal, commercial and technical considerations at this critical project stage.

Background

An agreement for lease relating to student accommodation expressly prevented the landlord from varying the proposed works in a way which would materially affect the size of the rooms. Any reduction of more than 3% was ‘material’. Although the works were completed, 56 of the rooms were found to be smaller than the planned size by more than 3%. The proposed tenant (Mears Ltd) complained that the certifier (Costplan Services (South East) Ltd) should not issue a certificate of practical completion due to these defects.

Mears brought claims against the landlord, contractor and certifier. It argued on appeal that the agreement for lease meant that practical completion of the works could not be certified as there were patent material defects (as well as the landlord’s breach of the agreement terms).

Decision

The Court of Appeal decided that the defects in the 56 rooms did not prevent their use as intended and therefore that the decision to certify could not be interfered with.

What this means for you

If you are certifying or deciding that a project is practically complete, follow this step-by-step guide:

1. If there is no express definition in the contract, then whether or not the works are practically completion is a question for the certifier;

2. Latent defects do not prevent practical completion – since they are not known about;

3. As far as certifying practical completion is concerned, there is no different between an outstanding item of work - which needs to be completed - and a defect - which needs to be remedied;

4. ‘Trifling’ outstanding items or defects do not prevent practical completion;

5. What is ‘trifling’ is a matter of fact and degree, measured against “the purpose of allowing the employers to take possession of the works and to use them as intended”. However, just because the employer can use the works as intended does not mean the works must be regarded as practically complete, regardless of the nature and extent of the items of work which remain to be completed/remedied; and

Whether or not a defect is capable of economic repair is irrelevant to the issue of practical completion (but goes to the proper measure of loss).

– [Mears Ltd v Costplan Services (South East) Ltd and others [2019] EWCA Civ 502]

For more information, please contact:

Ray Hetherington
Senior Associate
T: +44 121 232 1320
rayhetherington@
eversheds-sutherland.com

If the employer accrues delay damages but chooses to terminate, can it recoup those delay damages?

Summary

Depending on the wording of your contract, the client may not be able to recover liquidated or delay damages if the contract is terminated and the contractor never completes the works.

Background

In a contract for a new commodities trading, risk management and vessel chartering system, the client (PTT Public Company Ltd) agreed with the contractor (Triple Point Technology, Inc) that the contractor would pay agreed damages of 0.1% of the price of any undelivered work per day of delay.

The clause stated that the period during which these damages are payable was from 'the due of delivery up to the date PTT [the client] accepts the work'.

Following a dispute about payments, the contractor suspended work and left the client's site. PTT then terminated the contract based on PTT, counterclaimed the agree delay damages and damages arising from the termination of the contract. In the High Court, the client was awarded the delay damages and the contractor appealed.

Decision

The Court of Appeal allowed the client to recover delay damages for 149 days where the works in Stages 1 and 2 of Phase 1 were completed late, and accepted by the client. But it did not allow the client to recover delay damages for any other elements of the works, as those elements were never accepted.

Instead of agreed delay damages, the client can recover general damages for the delay as the contractor was a breach of the contract – this is more complex as the client has to prove breach, causation and its relevant losses.

What this means for you

Whether or not a client can recover delay damages following termination will depend on the precise wording of the delay damages provision. The wording in JCT 2016 suite, for example, the employer can deduct liquidated damages between the completion date and the date of practical completion.

Under NEC4 Secondary Option X7.1 delay damages are payable from the completion date until the earlier of completion (which refers to completion by the original contractor) and the date on which the client takes over the works.

You should check your contract to ensure that if you want to recover accrued delay damages after termination, they are expressly included in the clause either on delay damages or on the payments after termination.

Triple Point Technology, Inc. v PTT Public Company Ltd [2019] EWCA Civ 230

For more information, please contact:

Ray Hetherington
Senior Associate
T: +44 121 232 1320
rayhetherington@eversheds-sutherland.com

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Notification of Circumstances

Summary

When you have a possible claim against your professional indemnity insurance, a recent Court of Appeal decision confirms that you should notify early and in broad terms.

Background

Euro Pools specialised in the installation of swimming pools. It entered into two professional indemnity policies with an insurance company, RSA, for two periods 2006/7 (first policy period) and 2007/8 (second policy period).

Euro Pools identified defects with steel tanks affecting the operation of pool equipment at various locations. During the first policy period it notified these defects to RSA and stated they could be remedied using air bags. During the second policy period, Euro Pools notified RSA of a new proposed remedial scheme, using a hydraulic system, instead of air bags.

The remedial works when completed fully eroded the limit of indemnity for the first policy period. The insurers, RSA, argued that the new remedial works arose from the circumstance notified in the first policy period, and Euro Pools was not entitled to a further indemnity. The insured, Euro Pools, argued that the need for more extensive remedial works was not known when it notified during the first policy period; the costs of those works was therefore a new issue notified under the second policy period. if correct this would have given Euro Pools a second limit of indemnity. The insured was arguing for a narrow interpretation of its initial notification.

The High Court decided:

- the defects had not arisen at the relevant time for the notification of a circumstance under the first policy period;
- Euro Pools did not have the requisite knowledge of the defects, and could not notify something of which it was not aware; and
- Euro Pools was therefore entitled to a further £5,000,000 indemnity under the second policy period.

RSA appealed as it was incorrect to find that there was no causal link between the remedial works required and the circumstances notified under the 1st policy period.

The Court of Appeal said that Euro Pools faced potential claims from numerous third parties all arising from the problems notified under the 2006/7 policy. The issue was whether, objectively speaking, those potential claims arose from the circumstances notified in the first policy period. The technical reason for the problem would not have mattered to the third party claimants and it was irrelevant to the court's assessment or the knowledge of the insured or third parties at the time of the notification.

The Court of Appeal also decided that the claims arose from the circumstances notified as the connection was (as required) more than 'purely co-incidental'. Accordingly, the first notification encompassed all possible remedial schemes for the defect, and only one limit of indemnity applied.

What it means for you

Whilst insurers will continue to debate whether a claim arises out of circumstances already notified (and therefore come under the same limit of indemnity), for insured parties this decision encourages insured parties to submit notifications early and to draft them broadly to capture subsequent claims.

The decision reaffirms principles set out in HLB Kidsons v Lloyds [2008], that it is possible for an insured to notify a 'hornet's nest' of possible issues, whose cause is as yet unknown.

Employers considering insurance claims relating to insolvent contractors could validly notify defects to insurers early, even before their precise cause is known.

The Insurance and Reinsurance team in Eversheds Sutherland specialises in advising clients in the construction sector in relation to their rights and obligations under insurance policies (professional indemnity, project policies, CAR policies, latent defects policies etc) and pursuant to the insurance provisions of building contracts.

For more information, please contact:

Chris Ives
Principal Associate
T: +44 161 831 8191
christopherives@
eversheds-sutherland.com

UK Insights

Retention Payments in the Construction Industry

Summary:

The Construction (Retention Deposit Scheme) Bill was expected to have its second reading in Parliament on Friday 22 March 2019. If enacted it could make significant changes to cash flow in the construction industry. What is it and will it become law?

Introduction

Carillion’s insolvency, which left an estimated 30,000 SMEs in the UK construction industry without any chance of recovering the retention monies due to them, created a clear call for action to safeguard these monies.

On 9 January 2018, just days before Carillion’s collapse, a Private Member’s Bill - the Construction (Retention Deposit Schemes) Bill - was introduced in the House of Commons under the Ten Minute Rule and, unusually, passed its first reading.

The Bill was prescient and supporters said it was developed with a ‘large contractor insolvency’ nightmare in mind. The second reading of the Bill has been repeatedly delayed due to the distractions of Brexit, and the last date of March 2019 has come and gone with no new date being announced.

This UK Insight Article looks at what the Bill does, its supporters and detractors, international comparisons, and alternative solutions.

What The New Bill Does

The Bill seeks to amend the Housing Grants, Construction and Regeneration Act 1996 and broadly contains three limbs.

Firstly, the creation of ‘retention deposit schemes’ to safeguard retention monies withheld in connection with construction contracts and make it easier to resolve disputes relating to those retentions.

Second, a prohibition on retentions that are not placed into a retention deposit scheme.

Lastly, a duty to refund that any retention which is not placed into a retention deposit scheme. This has to be refunded within 7 working days after it was withheld.

Like most new payment mechanisms, this is likely to take time to become a new habit and will result in a rush of adjudication for those clients who forget to either place the money into a scheme quickly or refund that money equally quickly.

The system is similar to the UK statutory tenancy deposit scheme, under which deposits taken from shorthold tenancies must be placed in a Government-approved scheme.

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The Bill leaves much of the actual mechanics of the retention deposit schemes to be worked out in subsequent regulations but it still raises several questions:

- Will the Bill’s requirement for the schemes to make resolving disputes easier sit alongside or replace the well-trodden route of adjudication?
- Is the Bill intended to cover development and funding agreements, as its wide definition of construction contracts would suggest?
- Will the scheme apply to tier 2 and 3 contactors?
- Will the scheme apply to all contracts or just those above a certain value?
- Who pays the costs of administering the schemes?
- Who is entitled to the interest on the monies in the scheme?

The Bill’s Supporters

Sir Michael Latham’s 1994 Report, Constructing the Team, recognised the issues with the cash retention model and recommended either mandatory trust funds for payment or retention bonds. Whilst the option for on-demand retention bonds has been introduced into various construction contract standards forms, take up is low.

Since then the matter has been discussed in parliament and government-sponsored reports many times, and was the subject of two parallel consultations from the Department for Business, Energy & Industrial Strategy’s (BEIS). The Aldous Bill, as it is known, is not even the first Bill under the ten-minute rule. In April 2017, a Scottish MP (Alan Brown) introduced the Construction Industry (Protection of Cash Retentions) Bill – a general election curtailed that Bill’s progress.

Are there enough supporters to ensure this Bill’s success?

The industry publication Building Services and Environmental Engineer reported that this Bill commands the support of over 80 trade bodies and over 200 MPs and is ‘the largest fair payment campaign ever formed in the UK’.

In addition, the industry is very much in the public eye due to the high profile collapse of Carillion and other teetering main contractors. Industry publications, as well as the mainstream press, carry weekly stories about payment in construction. Many are scathing about the UK government’s attempts to improve payment solely through voluntary initiatives such as the Construction Supply Chain Payment Charter and the Prompt Payment Code.

It is not hard to see why the Bill has supporters. In our experience, the retention percentage is typically 5% of the contract sum (until completion, reducing to 2.5% during the defects period). When profit margins are hovering at 1.5% to 2%, the retention far exceeds any profit on a project and ensures contractors are operating at a loss until it is paid.

Staying in business becomes dependent on:

- the client or paying contractor remaining solvent for at least 12 months after completion (the defects period);
- countering any unsubstantiated or unscrupulous use of the retention for rectifying defects;
- the administrative challenge of keeping a record of what monies are outstanding to each member of the supply network across every project, each with a different timescale for the return of the retention;
- the cost and burden of chasing up someone with the authority to release the remaining retention falling on the subcontractors and suppliers;
- an English approach to 'not to causing a fuss' in the belief that to do so will maintain a better working relationship with upstream employers; and
- the prohibitive costs of enforcing contractual rights to the retention through adjudication, when those involved have long moved onto other projects.

The Bill's Detractors

Despite cross-industry support for mandating secured retention monies, 25 years have passed since Sir Michael Latham's report without any legislation enacting his recommendation. Surely it is not just a lack of parliamentary time (more recently caused by Brexit) preventing action?

Despite moves by more progressive employers clients such as Network Rail to remove retentions throughout its projects, there remains little support those in control of the chain of contracts: funders, employer and tier one contractors.

In our experience, these parties prefer the simplicity of retention. The alternatives - project bank accounts, retention bonds and trust funds – require additional legal, banking and administrative costs, none of which these parties want to pay for, especially when they perceive no personal benefit.

It is often stated, although no-one seems prepared to admit to it, that withholding retention improves the working capital of tier 1 contractors, and reduces the need for employer borrowing, both of which improve their balance sheets (if only temporarily).

Perhaps surprisingly, the lead organisation for the UK construction industry, Build UK, which – in theory – represents all levels of the supply chain, has not fully supported the Bill. Build UK (along with the Civil Engineering Contractors Association, Construction Products Association and Chartered Institute of Credit Management) set out their position in a letter to the Secretary of State for BEIS in which it restated its support for the outright abolition of retentions by 2025 as set out in the Governments Construction Supply Chain Payment Charter. And yet, Build UK sat on the fence and said that it had 'not reached a consensus on a retention deposit scheme' which is the foundation of the Bill!

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Patchy supply network support and difficulties with the finer mechanics of the schemes combined with lack of Parliamentary time jeopardises the ultimate progress of this Bill in the UK.

The NEC4 core conditions have no retention but there are Secondary Options for retention or a project bank account (to provide equivalent protection)".

International Comparisons

Following the Collins Inquiry, prompted by the aftermath of the financial collapse of a number of well-established building and construction companies, New South Wales in Australia introduced legislation mandating that tier 1 contractors must safeguard some retention monies. The Act applies to projects worth at least A$20m and the monies must be placed in trust accounts with an authorised deposit-taking institution. Consultations are reviewing halving this threshold to A$10m.

In New Zealand, after the collapse of developer Mainzeal, legislation requires retentions to be held on trust, unless a retention bond is in place. This applies to contracts throughout the supply network, with no minimum contract value threshold.

In Canada and the United States, a system of charges (liens) can be placed on an asset if a firm has not received its payments. France has a statutory framework that requires bank guarantees to be used as security for payment in the construction industry.

What Can You Do Now? Alternative Solutions

This Bill is mired in Brexit delays and lack of government will, and the lofty ambition of abolishing retention looks further away than the planned 6 years. What can you do before then?

Firstly, consider the provisions in your standard form contracts.

If you are using a JCT 2016 SBD or D&B contract, then if it requires an employer to hold retention monies on trust for the main contractor. In addition, "if the Contractor so requests" those monies have to be placed in a separate designated bank account designated. If used, and not amended or deleted, this provision offers the contractor the protection that the Bill seeks to replicate. Even though the JCT Subcontracts do not expressly include the requirement to hold the retention on trust, it is implied under English law unless the contract says otherwise. But the subcontractor cannot request those monies is placed in a separate account (and that may be because the contractor never gets paid them).

The NEC4 suite of contracts has no retention or retention bond but a Secondary Option can be used for equivalent protection by using a project bank account.

Secondly, consider the power of sector pressure and trade organisations. We routinely encounter responses from businesses in the vertical transportation sector where the contractors have decided they not accept a retentions and offer a specialist Lift and Escalator Industry Association Bond instead. The piling sector has a similarly strong anti-retention stance.

Of course, the biggest change would come if employers (backed by funders) created a long-term strategy reflecting the needs of the entire supply network. If employers require their long-term and framework contractors to protect retentions or remove them altogether, this would create significant benefits. Side-effects could be reduced costs (for example by subcontractors not having to price the risk of contractor insolvency), better working relationships based on higher trust, and more accurate tender prices taking into account real profit margins. and It is not impossible: Network Rail has banned retentions within its supply network and Highways England has adopted project bank accounts.

Conclusion

Main contractor insolvency, poor payment practices, heavy debts and low margins are a perennial feature of UK construction, provoking much worry in the supply network. The recent fate of leading contractor, Dawnus has been dubbed the 'Welsh Carillion'.

Despite our obsession with talking about improving payments, this Bill has slipped off the government's radar as it deals with other issues. Despite the progressive strategies of certain clients, housebuilder Persimmon recently announced it will allow homeowners to deduct retention, with the knock-on effects for its suppliers and subcontractors. Retention looks likely to remain an unwelcome guest for many in the industry, at least in the short term.

- **To read more about the Bill and its status in Parliament click here. See also our article on the use of Project Bank Accounts to solve some of these issues.**

For more information, please contact:

Thomas Taylor
Senior Associate
T: +44 121 232 1542
thomastaylor@
eversheds-sutherland.com

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What our clients say about us

Here are some of our most recent reviews which featured in Chambers and Partners UK Directory 2019

From Chambers UK 2019

"Ability to see the greater picture and suggest alternative approaches"

"They're very approachable, commercial and straightforward"

"The team "exceeded expectations" and were "very good at calling me every week to discuss performance with the whole team"

"They're very proactive and very sensible, and the strategy they formulated for their client was faultless as to how well it worked"

"Excellent knowledge of the law, and the particular nuances which apply, particularly to the large scale infrastructure projects on which it excels" and the team is "extremely well resourced and is therefore able to move very swiftly to put together impressive court materials and deal with litigation against a large number of respondents at short notice"

"Their strength and depth is great and their responsiveness is excellent"

Contacts

If you have any comments or questions, please contact one of the following:

For more information, please contact:

Simon Oats
Product Group Head
T: +44 20 7919 4750
simonoats@
eversheds-sutherland.com

For more information, please contact:

Jonathan Bowley
Partner]
T: +44 20 7919 4664
jonathanbowley@
eversheds-sutherland.com

For more information, please contact:

Simon Chamberlain
Partner
T: +44 161 831 8295
simonchamberlain@
eversheds-sutherland.com

For more information, please contact:

Jo Hatton-Jones
Partner
T: +44 113 200 4047
johattonjones@
eversheds-sutherland.com

For more information, please contact:

Dominic Lacey
Partner
T: +44 14 73 28 4574
dominiclacey@
eversheds-sutherland.com

For more information, please contact:

Rob McNabb
Partner
T: +44 29 2047 7852
robmcnabb@
eversheds-sutherland.com

For more information, please contact:

Peter Scurlock
Partner
T: +44 121 232 1188
peterscurlock@
eversheds-sutherland.com

For more information, please contact:

Alison Short
Partner
T: +44 29 2047 7378
alisonshort@
eversheds-sutherland.com

eversheds-sutherland.com