Fenwick Elliott

The construction & energy law specialists

Payment, security and challenging times

by Julie Stagg

Introduction

The education sector is adapting to the still challenging economic climate and must be pro-active in the face of increased insolvency risk at all levels of the supply chain. The sector must also adapt (as must other all other clients and their teams) to legislative changes which demand greater discipline in the commercial management of projects. This paper summarises the recent changes to the payment regime and offers practical advice to assist clients in dealing with the new process. The paper goes on to consider the issue of performance and payment security, which is of great importance when facing an uncertain future economically. Finally, the paper considers what other protection may be available to clients in the sector to relieve the adverse consequences of contractor insolvency.

Payment regime changes

Payment under the Housing Grants Construction and Regeneration Act 1996 ("Old Act")

The Old Act introduced the requirement for a construction contract to provide an adequate mechanism for determining what payments become due under a contract and when, and provided a final date for payment in relation to any sums which become due. These provisions remain in the New Act.

A payment notice (section 110 notice) was required, under which the paying party informed the payee of the amount proposed to be paid and the basis on which that amount was calculated. However, the Old Act contained no sanction for failure to provide a payment notice and in practice often they were not used.

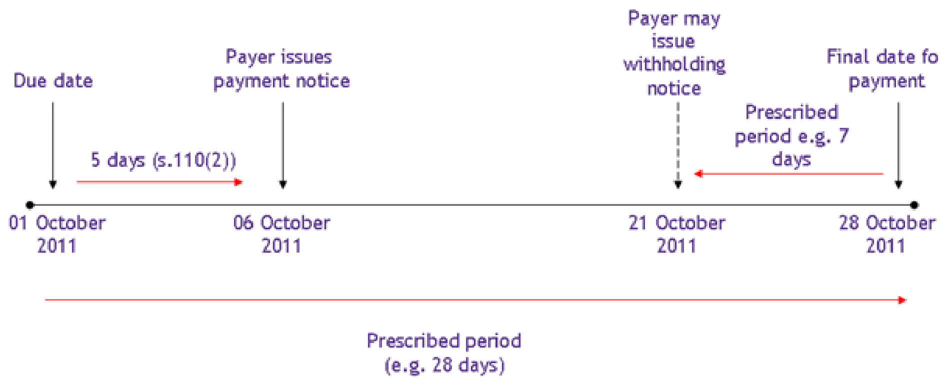
Any paying party wishing to set off a sum against the amount otherwise due to the payee under the Old Act (i.e. the sum set out in the payment notice, valuation or certificate) could do so by serving a withholding notice (section 111 notice) within the prescribed period before the final date for payment. The Old Act required the party seeking to withhold payment to set out the amount or amounts proposed to be withheld and the ground or grounds for each amount.

The absence of a withholding notice has become a way to secure the amount valued or certified through adjudication proceedings. The courts have held that in the absence of a withholding notice, the receiving party was entitled to be paid the amount set out in any valuation or certificate.[1]

The Old Act regime will continue to operate for the duration of any contract entered into before 1 October 2011. It is therefore useful now to provide an update as to how the payment provisions operate, the notices which must be served and the timetable for doing so.

The sequence of events required for payments under the Old Act regime is set out below.

[1] See, for example, *Rupert Morgan Building Services Ltd v. Jervis and Another* 2004 1 WLR 1867.



Under the Old Act, the withholding notice is the most important document which is required to be served in order to pay a lesser amount than the amount which has been valued or certified. Failure to serve a withholding notice means that the paying party is entitled to payment of the amount due as set out in the section 110 payment notice, valuation or certificate. If the sum due is not paid, the party which had not been paid can start an adjudication to recover the amount due, which is likely to be successful, or it can suspend the performance of its works.

Pay when paid clauses

Before the Old Act, it was permissible for the main contractor not to pay any of its subcontractors if it had not received payment from the client. The Old Act outlawed "*pay when paid*" clauses from construction contracts. One exception where such provisions were permitted was when the client, or any other party up the line, was insolvent.

The Old Act defined the circumstances in which a client became insolvent. Any construction contract seeking to incorporate a pay when paid clause must define the circumstances of such insolvency events so as to comply with the Old Act. The relevant section of the Old Act (section 113) was amended by new insolvency legislation[2] and the list of insolvency events changed. If parties' construction contracts were not updated to incorporate this change, the provision was held not to be effective to prevent the main contractor from paying its subcontractors when the client had become insolvent by the "new" insolvency event.[3]

Suspension

A further sanction introduced by the Old Act for failure to pay a sum due under a construction contract where there was no withholding notice was the right of the unpaid party to suspend performance of its obligations under the contract. The Old Act states that, "*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 has been given …*" the unpaid party could suspend. There was some confusion as to which document set out the "*sum due*", whether it was the application for payment or the section 110 payment notice, valuation or certificate. In our view the sum due under the contract is the payment notice, valuation or certificate and not the application.

A notice of suspension is required to be served at least seven days before performance can be suspended. This notice has to set out the grounds on which it is intended to suspend performance. The right to suspend continues until the party in default has made payment in full of the amount due.

The right to suspend remains under the New Act with some minor amendments.

[2] The Enterprise Act 2002, which amended the Insolvency Act 1996 and impacted upon the circumstances.
[3] See William Hare Ltd v. Shepherd Construction Ltd 2010 BLR 358.

Practical advice

The most important notice under the Old Act was (and remains) the section 111 withholding notices; payment notices were often ignored as there was no sanction on a paying party for failing to provide a payment notice. In the withholding notice the paying party is required to inform the payee not later than a prescribed period before the final date for payment of the amount or amounts it proposes to withhold from any payment otherwise due and to set out the ground or grounds for that withholding.

Withholding notices will continue to be important in all contracts entered into before 1 October 2011 and to which the Old Act regime applies. It is possible, and in our view good commercial practice, for paying parties (where it does not already do so) to start to issue payment notices under the Old Act regime on these contracts, as the New Act requires payment notices to be provided and there are sanctions if a party fails to serve a payment notice under the New Act. This will improve commercial management on the Old Act regime contracts and will assist in the administration of contracts under the New Act regime.

Payment under the LDEDCA 2009 ("New Act")

The provisions of the New Act in respect of stage payments apply to all contracts unless the contract states that the duration of the work is to be less than 45 days or the parties agree that the duration of the work is estimated to be less than 45 days. All other construction contracts must provide an adequate mechanism for determining what payments become due under the contract, and when, and provide a final date for payment of any sum that becomes due.

The parties to the construction contract are free to agree the due dates for payment in their contract. The parties to the construction contract are also free to agree how long the period is to be between the date a sum becomes due and the final date for payment. The New Act prescribes the periods for payment notices and default notices, but are free to agree the last date before the final date for payment on which pay less notices must be served. Under the Old Act, the parties were free to agree all of these periods.

If the contract does not comply with the Act, the payment provisions of the Scheme will apply.[4]

New timetable

Under the Old Act the important dates to remember in respect of a payment cycle were the due date, the final date for payment and the last date upon which a withholding notice could be served.

The New Act introduces a different regime with increased emphasis on the first notice by the paying party, which replaces the often unused payment notice under Section 110 of the Old Act.

Payment notice

The New Act provides that the payer or a specified person (defined as a person specified in or determined in accordance with the provisions of the contract, namely a client's agent, contract administrator or quantity surveyor) shall give a notice to the payee not later than 5 days after the payment due date.[5] The payment notice must set out the sum that a payer considers to be due at the payment due date and the basis on which that sum is calculated.

4 See Section 110(3) of the New Act.
5 See Section 110A(1)(a) of the New Act.

The New Act does not specify or clarify what is meant by "*basis on which the sum is calculated*."[6]

A payment notice must still be served even if the amount calculated as due is nil.[7] Even if the total of the abatements and set-offs reduces the amount due in the payee's notice to an amount the paying party is prepared to pay, a pay less notice may still be served not later than the prescribed number days before the final date for payment, which may be an agreed date or the Scheme period of 7 days.

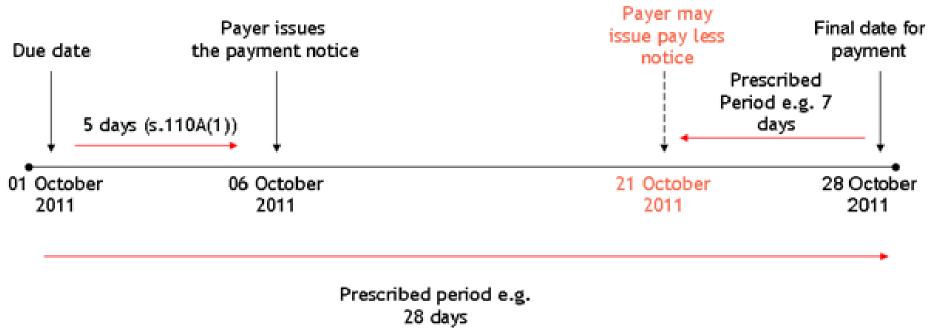
Practical advice

As a matter of good commercial practice, parties should serve very detailed payment notices downstream. To satisfy the New Act's requirement for the "*basis on which the sum is calculated*" to be set out, at the very least the mathematical calculation of the amount applied for, any reduction calculated during the valuation (for reasons such as work not carried out in accordance with the contract, abatement, and arguably set-off, which would under the Old Act regime have been dealt with in the withholding notices) ought to be included in the payment notice. Alternatively, it would be good practice to provide in the payment notice a similar level of detail to that provided by the payee in any application for payment.

The more detail which is included in the payment notice, the more information the party to whom payment is due has to assist it in understanding the basis of the valuation which ultimately should reduce the risk of disputes arising.

Payment notice flowchart

The following flowchart shows the procedure to be followed where a paying party serves a payment notice.



The parties are free to agree the dates on which the amount becomes due and the final date for payment. However the New Act states that the payment notice must be served within 5 days of the due date.[8] The parties may agree the last date before the final date for payment on which a pay less notice may be served, in default of which the Scheme applies which requires the pay less notice to be served not later than 7 days before the final date for payment.

Notice in default

If the paying party or a specified person fails to serve a payment notice, the payee can give a notice in default of the payer's notice.[9]

This notice in default can be given at any time after the date on which the payment notice should have been served. Any delay by the payee in serving a notice in default after the date on which the payment notice was due has passed will result in a extension to the final date for payment by the same number of days as elapses between the last date for service of the payment notice and the date on which the default notice is served.

[6] Section 110A(1)(b) also provides that the payee may give a notice to the payer or a specified person not later than five days after the payment due date along the same lines as a payer notice. However, we would not recommend providing for this within your construction contract and the rest of this paper deals with the procedures where the construction contract provides that the payer issues the payment notice under Section 110A(1)(a).

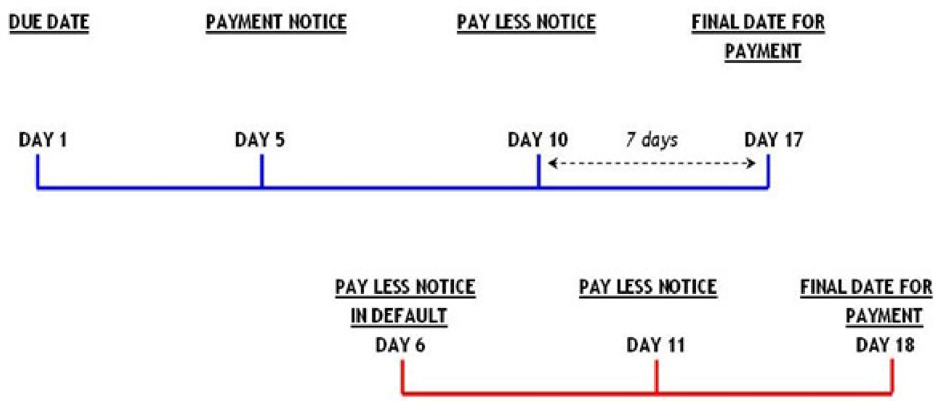
[7] See Section 110A(4) of the New Act.

[8] See Section 110A(1) of the New Act.

[9] See Section 110B of the New Act.

For example, using the Scheme timetable (see below):

NEW SCHEME



Application for payment as notice in default

If the payee has issued an application for payment to start the payment timetable, the New Act provides that any such application made before the payment notice may stand as the payee's notice in default and that the payee may not serve another notice in default.[10]

In the absence of a pay less notice, the amount applied for becomes the notified sum which must be paid in full without any abatement, deduction or set off by the final date for payment.

Pay less notice

Following the service either of a payment notice or a notice in default, the paying party is required to pay the notified sum, i.e. the amount set out in the payment notice, default notice or the payee's application for payment.[11] The notified sum must be paid and arguments as to whether or not a sum is properly due under the contract are no longer available to the paying party.[12] The only mechanism by which payment of the notified sum can be avoided is by the service of a pay less notice.[13]

The paying party must set out in the pay less notice the sum which it considers to be due on the date the pay less notice is served and the basis on which this sum is calculated. The number of days before the final date for payment when the pay less notice must be served can be agreed in the contract, in default of which the Scheme applies and the pay less notice must be served not later than 7 days before the final date for payment.

Again, as with the payment notice, the requirement in the New Act is for the pay less notice to set out the basis on which the sum is calculated. This is different from a withholding notice under the Old Act, which required the paying party to set out the amount proposed to be withheld and the ground or grounds for withholding that payment.

Practical advice

At a minimum in our view, the mathematical calculation of the notified sum less any amounts which the paying party does not propose to pay ought to be set out in the pay less notice. As a matter of good commercial practice, we would suggest that when a party is the paying party that it sets at least out a similar level of detail as is set out in the application for payment.

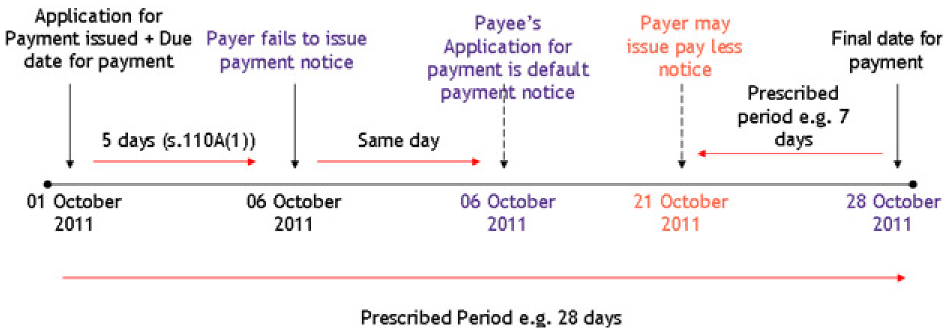
10 Section 110B(4) of the New Act.
11 See Section 111(1) of the New Act.
12 See Section 111(4) of the New Act.
13 See Section 111(3) of the New Act.

We would suggest that the paying party goes further and includes the level of detail required by the Old Act's withholding notice, i.e. setting each ground of withholding and amounts which add up to the total of the pay less notice. This would in our view reduce the possibility of disputes arising but, if a dispute did arise, the detail in the notice would improve the paying party's position in any subsequent adjudication.

This may be a sensible approach to adopt during the transitional period in any event as it will prevent any differences arising in the approach adopted in respect of the different types of notice that need to be prepared. If a pay less notice were mistakenly served under a contract governed by the Old Act regime, the pay less would then in any event comply with the requirements of a withholding notice.

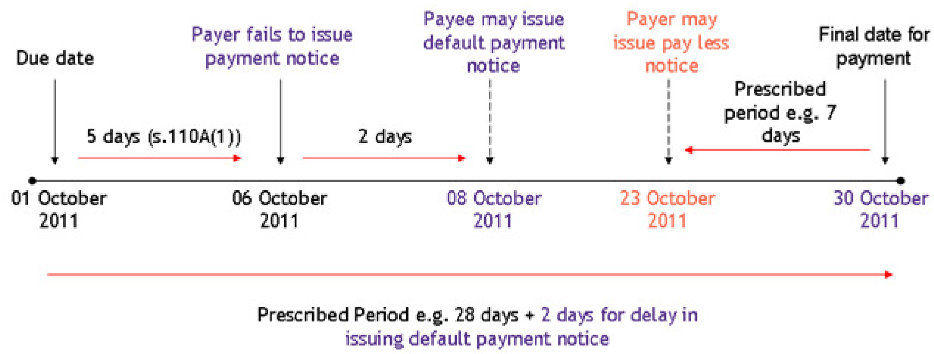
Payment flowcharts – no payment notice served

The first flowchart below sets out the procedure where a payee makes an application for payment but the paying party fails to serve a payment notice, resulting in the application standing as the notice in default and setting out the notified sum.



In this scenario the paying party is able to remedy its initial failure to serve a payment notice by serving a pay less notice. The amount payable by the final date for payment is therefore the notified sum, in this case the amount sought in the application for payment, less any amount set out in the pay less notice.

The following flowchart shows the procedure where a payment becomes due without the payee making an application for payment and where no payment notice is served. Here the payee has served a notice in default which sets out the notified sum.



Again in this scenario the paying party is able to remedy its initial failure to serve a payment notice by serving a pay less notice. The amount payable by the final date for payment is therefore the notified sum, in this case the amount set out in the notice in default, less any amount set out in the pay less notice.

The worst case scenario for a paying party would be if it failed to serve a payment notice and also failed to serve a pay less notice. In these circumstances, the amount applied for or the amount set out in the notice in default would become the notified sum which would need to be paid without abatement, deduction or set off by the final date for payment.

The pay less notice is therefore a critical document which must be served in all circumstances.

Practical advice

Parties should ensure that in all downstream contracts that the payment timetable is commenced by the issuance of an application for payment. The clause should say that the payment due date is a set period after receipt of the application (say 14 days).

The 'paying' party should value the application within this period and ensure that a detailed payment notice is served as soon as possible after the due date and in any event within 5 days; in no circumstances should a payment notice not be served, even is the amount considered to be due is nil.

The New Act allows the parties to agree the number of days before the final date for payment on which the pay less notice may be served. In the absence of an agreement, the Scheme provides that a pay less must be served 7 days before the final date for payment.[14]

Parties may wish to consider inserting a clause into its contracts/subcontracts which provides for the pay less notice to be served one day before the final date for payment. This will allow all abatements, set offs or deductions the longest possible period to come to it's attention to ensure that they are taken into account before the final date for payment. However, with this in mind, the parties need to be sure that their internal procedures are sufficiently robust to cope with service of notices so close to the deadline. Otherwise, missing the opportunity to issue a pay less notice becomes a real risk.

Payment under the New Scheme

The Scheme has been revised to reflect the changes introduced by the Act. If a construction contract has not been agreed in writing, or if it does not contain an adequate mechanism for payment, the payment provisions of the Scheme apply or will replace the inadequate contractual provisions. It is important therefore to consider the requirements and timetable of the new Scheme.[15]

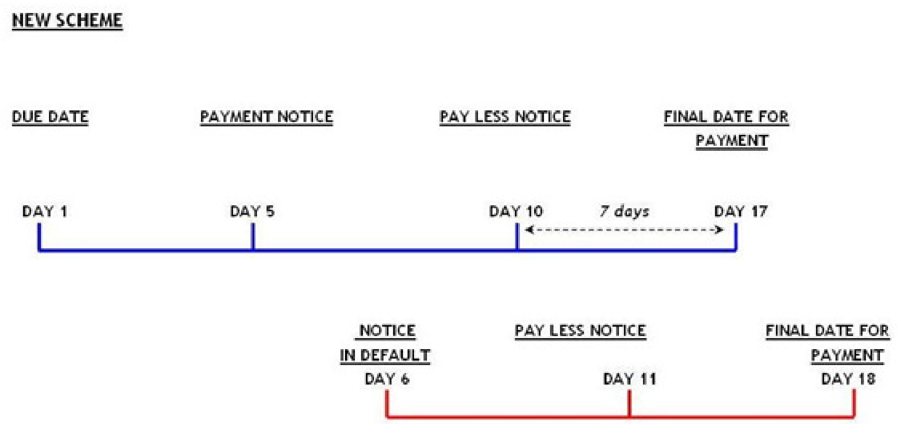
The Scheme provides that the payment notice required by section 110A(1) of the New Act must serve a payment notice not later than 5 days after the payment due date.[16] This reflects the requirements of section 110A(1) of the New Act.

The Scheme does not contain any provisions in respect of the payee's notice in default. The New Act provides sufficient guidance in this regard; if it has not issued an application for payment (which automatically stands as the notice in default) the payee ought to serve a notice in default as soon as possible after the 5 day period for serving the payment notice has elapsed.[17] Any period of delay causes a consequential delay to the final date for payment.

The Scheme requires the pay less notice to be served no later than 7 days before the final date for payment.[18]

The final date for payment under the Scheme is 17 days from the due date.[19] The timetable for payment and notices under the Scheme is shown below.

[14] See Paragraph 10 of the Scheme.
[15] See Section 110(3) of the New Act.
[16] See Paragraph 9(2) of the Scheme.
[17] See Section 110B(1)(a) of the New Act.
[18] See Paragraph 10 of the Scheme.
[19] See Paragraph 8(2) of the Scheme.



Additional provisions in respect of payment

In addition to the new notice regime, the New Act has introduced some further changes. In order to provide an adequate mechanism for payment, a construction contract cannot make payment conditional on the performance of obligations under another contract or a decision by any person as to whether obligations under another contract have been performed. Such provisions are known as "*pay when certified*" clauses. A main contractor cannot therefore provide in the contract that payments to subcontractors are conditional upon the client certifying payments to the contractor under the main contract.

If a construction contract contains a pay when certified clause it will not satisfy the requirements of an adequate mechanism for payment for the purposes of the New Act and the payment provisions of the Scheme will be imposed, with its shorter timetable.[20]

Retention

As the New Act prevents payment under a construction contract from being conditional upon the performance of obligations under a separate contract, this is likely to have a significant impact in respect of retention.

Construction subcontracts frequently provide that the payment to the subcontractor of the final moiety of retention is conditional upon the contractor receiving a certificate of making good defects under the main contract. Such clauses will no longer be permitted.

Contractors in particular will want to prevent a situation from arising where a subcontractor's second moiety of retention becomes due too early and exposes the main contractor where there is defective work, no certificate of making good defects under the main contract and no retention fund available from its subcontractor. We suggest contractors include a provision that the second moiety of retention will be released in accordance with the date in the articles or contract particulars. The date for release of the second moiety of retention, or number of days from completion of the subcontract works, will need to vary in respect of each subcontractor due to the time during which the project they complete their works; the demolition contractor will complete its subcontract works long before the painter.

Such a provision will protect contractors from the situation outlined above and will not affect the Act as the payment of the second moiety of retention is not conditional upon a certificate being issued under another contract.

[20] See Sections 110(10) and 110(3) of the New Act.

Insolvency

Section 113 of the New Act remains as it was under the Old Act, namely that pay when paid clauses are not permitted unless the party up the line is insolvent. All of the insolvency events set out in the Enterprise Act are included. There are further definitions in respect of the insolvency of a partnership and individuals.

Section 111 (10) of the New Act excludes the requirement to pay the notified sum on or before the final date for payment where the contract provides that such a payment need not be made if the payee becomes insolvent. This applies even after the date for serving a pay less notice has passed.

This statutory provision effectively incorporates the decision of the House in Lords in *Melville Dundas Ltd v. George Wimpey UK Ltd* (Scotland)[21] but ensures that it is restricted to defined insolvency situations.

Suspension for non-payment

The Old Act introduced the right for a party which had not been paid to suspend performance of its obligations under the contract.

The New Act has retained the right of a party which has not been paid to suspend, but has amended the Old Act slightly.[22]

The ground on which a party may suspend its works has been clarified in the New Act. A party may suspend if the payer does not pay the notified sum on or before the final date for payment.

Clients should be aware that the New Act allows the party which has not been paid to suspend "any or all" of its obligations under the contract. This means that a party can suspend performance of part of its works. This could be used for tactical advantage and a party could suspend one particular element of its services.

In addition, the New Act has introduced an entitlement for the party which has not been paid and has chosen to suspend its works to be paid by the defaulting party a reasonable amount in respect of cost and expenses reasonably incurred by that party as a result of the exercise of the right to suspend.

Further, the right introduced by the Old Act to exclude the period of any suspension from the computation of the completion date has been extended slightly to include a period "*in consequence of the exercise of*" the right to suspend. This additional wording seem to us to cover any time spent by the suspending party in demobilising and remobilising.

The requirement to notify the defaulting party at least seven days before the right to suspend its performance remains in place.[23] Failure to comply with this notice provision may mean that the party seeking to suspend does so in breach of contract, which could be construed as a repudiatory breach bring the contract to an end.

Transitional Period – Payment

During the transitional period, Parties may be operating two distinct payment regimes with separate timetables, notice provisions and timetables for payment.

[21] [UK] UKHL 18.
[22] See Section 112 of the New Act.
[23] See Section 112(2) of the New Act.

Careful and thorough commercial management is therefore essential to ensure that the correct regime is operated in respect of the correct contract, the correct notices are served and any payments are made within the correct time period.

Whereas under the Old Act the section 110 payment notice was often (and could be due to the lack of sanction) ignored, the payment notice under the New Act is more important and should always be served and in our view should be as detailed as possible. If there is to be any confusion between the Old Act and New Act regimes, parties would be in a far better position if it adopted the New Act procedure and served a payment notice within 5 days of the due date on all of its contracts.

Failure to serve a payment notice allows the payee to control the amount of the notified sum, either by its application or by serving a notice in default. The payer can still remedy this situation by serving a pay less notice.

Failure to serve a pay less notice where a payment notice has been served may be painful for the paying party, as it will have lost its second opportunity to reduce the amount payable on or before the final date for payment. However in this situation the paying party ought to have valued the payee's entitlement and deducted all abatements and set offs in the payment notice.

The worst case scenario for a paying party is failing to serve a payment notice (the amount set out in the payee's application or notice in default becomes the notified sum) and then subsequently failing to issue a pay less notice. The amount applied for by the payee or set out in its notice of default then becomes the amount payable on or before the final date for payment without abatement, deduction or set off. Good commercial management is essential to avoid this situation from arising.

Bonds, Warranties and Guarantees

Bonds and Guarantees: the basic legal principles

These are the two most common forms of security taken by clients on construction projects and, from a legal point of view, have much in common. However, there is a great deal of misunderstanding about the legal principles underlying them which is not helped by the numerous names which are applied to bonds and guarantees in the construction industry. These include: on-demand bonds, simple bonds, performance bonds, conditional-demand bonds, bank guarantees, demand guarantees, default bonds, performance bonds, surety bonds, surety guarantees, parent company guarantees.

It is important to look beyond the names applied to these documents. The label attached to a document is not conclusive as to the legal principles upon which it is based. Essentially the document should be based on one of two fundamentally different legal principles (but obviously the specific drafting means the position is often less clear than it could be and frequently results in a document falling somewhere in between these two principles).

(i) Primary obligation. This is simply an undertaking from the bondsman to pay a sum of money to the client without reference to the liability of the contractor. It is this principle which underlies a true "on-demand" bond. These bonds are common on international projects but less so in the UK (except in the case of advance payment and retention bonds).

(ii) Secondary obligation (guarantee). This is where the bondsman's liability to pay the client is contingent upon a breach by the contractor of the underlying construction contract. So if the client cannot establish a breach by the contractor then the bondsman has no liability to pay. It is this principle that underlies the default bond, which is the more common form of bond used in UK projects, i.e. performance bonds, parent company guarantees etc.

It is not always clear to distinguish whether a bond is truly on-demand or whether it is conditional upon breach of the construction contract. Clever (or not so clever) drafting also sometimes means that bonds fall somewhere in between. Some examples:

- In a true on-demand bond you would usually expect to find wording along the following lines:

  "I promise to pay you £X on receipt of your written request without proof or conditions".

Wording to this effect is unusual in bonds used in UK construction projects and bonds tend to have conditions attached to them to limit a call. Unsurprisingly, these are known as conditional on-demand bonds. These conditions may include:

- A statement (usually from the architect/engineer) that the contractor is in default;
- Enclosing copies of warning notices served on the contractor under the main contract;
- An adjudicator's award.

These provisions should not detract from the bond being an on-demand bond; it simply places hurdles in the way of a claim. There is no suggestion that any default on the part of the contractor needs to be demonstrated - the conditions are simply administrative. A true default bond would usually include wording such as:

> "The Guarantor guarantees to the client that in the event of a breach of the Contract by the contractor the Guarantor shall discharge the damages sustained by the client as established and ascertained pursuant to and in accordance with the Building Contract"

The confusion that can arise where bonds sit somewhere in between true on-demand and default bonds has been considered recently in the Australian case of *Clough Engineering Limited v Oil and Natural Gas Corporation Limited*.[24] Clough was an engineering company engaged by ONGC in relation to the development of oil and gas fields off the coast of India. Various disputes arose which culminated in ONGC terminating the contract and making a call on the bond. The wording in the construction contract between Clough and ONGC provided that Clough was to provide an unconditional and irrevocable bond and ONGC would have the right to claim an amount up to 10& of the value of the contract "*in the event of the contractor failing to honour any of the commitments entered into under this contract*".

The wording of the bond itself provided for the bank to pay immediately on first demand:

> "*on breach of contract by the contractor without any demur, reservation, contest or protest or without reference to the contractor.*"

Clough maintained that the wording in the contract prevented a demand being made and that ONGC had to prove breach on the part of Clough before a claim could be made

[24] [2008] FCAFC 136

on the bond. The Judge at first instance rejected this and held that it was sufficient for ONGC to call the bond where it had a bona fide belief that Clough was in breach. When both the contract and the bond were considered together it was clear that a claimed breach of contract was sufficient to trigger payment under the bond. This decision was upheld on appeal.

Formality

A guarantee, which is the legal basis of true default bonds, is similar to a simple contract in that all the requirements for a contract must be present, such as an intention to create legal relations, consideration, etc. In addition to this, a guarantee must be in writing to be enforceable. In the Action Strength Limited[25] case a subcontractor sought payment directly from the client where the main contractor had become insolvent. The subcontractor's claim was on the basis that the client had said that the subcontractor should carry on working and that the client would ensure that he got paid. The sub-contractor's claim failed on the basis that the apparent "guarantee" by the client in respect of the main contractor's payment obligations had not been recorded in writing and so could not constitute a guarantee. This case is obviously a warning to contractors and subcontractors who proceed on the strength of a verbal assurance from a third party that they will be paid. The effect of the verbal assurance is probably intended to act as a guarantee but must satisfy the requirements of a guarantee before it can be relied upon.

Co-extensiveness

This principle provides, in practice, that the bondsman is only as liable as the contractor but this only applies to secondary obligations. Under an on-demand bond the extent of the bondsman's liability is dictated solely by the wording of the on-demand bond itself. Essentially, the bondsman is put in the same position as the contractor under a default bond.

Further to the above, it is in the clients best interests to try and achieve co-extensiveness throughout the life of a contract (whether that be 6 or 12 years) when negotiating a bond or guarantee. However, many parent companies or bondsmen only offer a bond/guarantee for the duration of the project, or at the very latest on expiry of the 12 month defects liability period. Whilst an expiry period linked to practical completion or the end of the defects liability is more readily accepted for bonds, many clients do insist on co-extensive parent company guarantees wherever possible.

Variation of the construction contract

One of the basic rules of a guarantee is that any variation in the construction contract could discharge the bondsman from liability. It is for this reason that the following will usually be present in any default bond:

> "The Guarantor shall not be discharged or released by any alteration of any of the terms, conditions and provisions of the Contract or in the extent or nature of the Works and no allowance of time by the client under or in respect of the Contract or the Works shall in any way release, reduce or affect the liability of the Guarantor under this Guarantee Bond"

There is no need for such wording in on-demand bonds because they are a primary obligation operating independently of the underlying construction contract. However, just because a bond does not contain this wording is not conclusive that it must be an on-demand bond; it is necessary to look at the precise wording in each case.

25 [2003] UKHL 17

A word of warning about relying on such wording. If the amendment to the construction contract is significant then it is still advisable to get the consent of the bondsman. Hackney Empire Ltd v Aviva Insurance UK Ltd [21.09.11] supports the principle that a performance bond including an indulgence clause (as above) protects clients where contractual variations are made without consent, but not without qualification.

Framework agreements

It is also important to consider how guarantees may be affected by more modern procurement routes such as framework agreements. The main advantage of frameworks is that contracts are "called off" as and when the client wishes during the framework, with the intention that certain aspects of the project are agreed in advance - one of the most common being the terms and conditions. Frameworks are frequently used by Estates Departments to achieve efficiencies in their supply chains and to promote collaboration and innovation.

When setting up this type of arrangement it is important to consider how any guarantee is drafted. Firstly, frameworks in the private sector have a tendency to go beyond the scope of what was intended of the contractor at the outset. A contractor who has completed a number of successful projects for a client can soon find himself undertaking more complicated and high value projects. Therefore it is important that the client understands what it is getting, and that its long term requirements are covered. Frameworks in the public sector, which are usually subject to OJEU, will be more carefully regulated as regards the scope and value of the projects called off under them.

If the guarantee obtained is in relation to all the obligations assumed under the framework, and these obligations materially change in scope and duration, the guarantor may be discharged. Secondly, careful attention must be paid to the wording of the framework agreement. Often, they are written so that the contract between the parties for the actual work is a separate contract from the framework agreement itself. Any guarantee will need to take account of this.

The meaning of default

As previously mentioned, the most common form of bond issued on UK projects is the default bond as opposed to the on-demand bond. If there is no "default" then no call can be made on the bond (unlike the on demand bond which is a primary obligation not dependent upon any default under the construction contract).

Default bonds are most commonly underwritten by insurance companies (with banks tending to underwrite on-demand bonds) and so, like any other insurer, they will look for a reason to avoid payment. That said, on many occasions the bond issuer will accept a call on the bond simply by demonstrating that the contractor is insolvent and then providing evidence of the actual costs of completion of the construction work. The key practical approach in these situations is to get the bondsman involved early. It is important to remember that the more the client is able to demonstrate that the losses have been reasonably incurred (and properly mitigated) the less chance there is of the bondsman challenging those losses.

However, establishing "default" is not always straightforward and things do not always go smoothly with the bondsman. Given that one of the main reasons a client will want to call a bond is due to the contractor's insolvency there have been a number of cases which have doubted whether insolvency is actually a default entitling a call to be made.

Involving a bondsman at an early stage can be beneficial to the client. On a recent project, as soon as the contractor became insolvent we involved the bondsman. The various options as to how to complete the works were discussed and "signed off" by the bondsman. These options included tendering the remaining works on a fixed price basis (but with the risk of overrunning and the client becoming liable to a tenant for liquidated damages), or completing the works on a day works basis with far less risk of overrunning and incurring liquidated damages but obviously with less cost certainty. Because of the early involvement of the bondsman the losses were clearly demonstrated, mitigated and settled without delay on the part of the bondsman.

In Perar BV v General Surety and Guarantee Co Ltd[26] the building contract terminated because the contractor went into administrative receivership. The contract was the JCT Standard Form of Building Contract with contractor's Design 1981 Edition. Clause 27.2 provided:

> *"In the event of the contractor having an administrative receiver, as defined in the Insolvency Act 1986, appointed the employment of the contractor under this Contract shall be forthwith automatically determined"*

The client made a call on the bond but the Court of Appeal held that the client could not treat the automatic determination of the employment of the contractor as an abandonment of the contract amounting to repudiation. This was because the contract expressly set out what was to happen in such circumstances and set out what liability each party had to the other. It is for this reason that a well-drafted bond should always make clear that termination in these circumstances is a default for the purposes of the bond. For example:

> "The Guarantor guarantees to the client that in the event of a breach of the Contract by the contractor or in the event that the Contract or the employment of the contractor is determined by reason of one or more of the events set out in clause [insolvency clause] and notwithstanding any objection that may be raised the Guarantor shall [satisfy the damages sustained]."

Parent Company Guarantee v Default Bond

Given that default bonds are essentially based on the law of guarantee (and so many of the same issues arise) it is often queried why some project documentation still requires both forms of security and whether there are any advantages with one over the other.

Many contractors will argue that it is unreasonable for the client to request both a PCG and default bond. However, whilst legally they may have many similarities the practicalities of how and when they operate means that the client's request for both can often be justified.

The PCG can be a very practical as well as legal remedy. If a subsidiary is not performing then in practice the client will simply threaten to make a formal call on the PCG. In many cases this is sufficient to ensure that the parent company steps in and resolves the problems with its subsidiary's performance. The risk, of course, is that if the grounds for non-performance by the subsidiary are financial then there remains a high chance that the parent company may suffer the same fate. It is in these insolvency situations where the bond is likely to prove better security for the client (subject, of course, to the financial standing of the bondsman).

The other major advantage to the PCG is that they tend to be drafted on the basis that the parent company's liability is identical in terms of duration as its subsidiary. By contrast

[26] (1994) CA 66BLR77

most default bonds are drafted to expire at the end of any defects period meaning that latent defects appearing after this date are not caught.

Payment security for the contractor

Capital projects in the education sector are sometimes procured by special purpose companies established by a university or college solely for project delivery. Considered by some to be a more tax efficient approach to development for clients in education, we are aware of and work with a number of development companies. Contractors and consultants entering into agreements with these special purpose companies often do have 'an eye on the balance sheet' and will look for payment security from their prospective clients if they have concerns about the covenant of the development company. Such concerns may not be addressed simply by a 'letter of comfort' from the relevant institution; payments guarantees or 'escrow' accounts (administered by a bank or solicitor) are commonly requested.

When an educational institution is considering whether or not to provide a guarantee in respect of a contract entered into by its subsidiary, it is best advised to propose its own form, which should be a limited guarantee relating only to the development company's payment obligations. If an escrow account is discussed as an alternative, the client should bear in mind the likely administrative costs. Close attention should also be paid to the wording of the escrow agreement, so that the 'triggers' for drawing down payment are clear and appropriate in the circumstances.

Practical advice

Negotiating a Bond or Guarantee:

1 Clients proposing a bond or guarantee should have a draft "model" form of wording available for the contractor's consideration at tender stage. Where a model form is being used, parties should still approach so called "tried and tested" precedents with caution. Precedents are only tried and tested to the extent that they have not been analysed by a Court and found to be wanting. It is entirely possible that a precedent form may have been used previously without those signing it have ever fully understood its effects.

2 Some general points ought to be considered on first review of a draft form of wording for a bond or guarantee:

2.1 Does the text include phrases like "on-demand", "without proof or condition", "primary obligor" and "indemnity"? (These will obviously point to an intention to impose a primary obligation).

2.2 Is it intended that the guarantee or bond is to be issued by a bank (or by a specific bank) or by a parent company?

2.3 Does the wording mention a fixed or maximum value of the security required?

2.4 Does the wording read like something out of a Victorian novel?

2.5 Is there apparent evidence of amendment of a standard form?

3 The priority when being presented with a draft document should be to establish whether or not the client is looking for security in the form of a primary or

secondary obligation. Any request for an on demand bond in a domestic context will be firmly resisted by contractors, and clients should expect to have to fully justify why it feels the need to have such a potentially drastic security option. In most circumstance the negotiated position will be the offer a conditional bond as a reasonable alternative by the contractor or dependant on the strength of a clients negotiating position a negotiated maximum sum. (In the *Edward Owen Engineering Ltd v Barclays Bank International Ltd*[27] case the sum covered was for 10% of the contract price).

4 Turning to the small print, as with any other contract the general question to think about when considering the detailed terms and conditions is something like: "*Does the wording clearly describe the obligations of the parties and prescribe the outcomes for all of the relevant eventualities.*" If the client wants a primary obligation and the contractor is willing to concede this then it is in the interests of both parties to make sure this is clearly expressed so that future disputes may be avoided.

5 It is important that the small print is <u>consistently</u> clear (ambiguity leads to arguments) as to the following issues:

5.1 The nature of the obligation imposed.

5.2 The period over which the obligation is to be maintained and/or the expiry date.

5.3 The maximum or aggregate maximum sum payable.

5.4 The mechanism by which notice of demand is be provided.

5.5 What amounts to a default?

5.6 If it is necessary for a loss to be "sustained" and how that sustained loss is to be proved.

5.7 Those events that will discharge the guarantor's obligations.

5.8 How disputes are to be resolved and pursuant to what law (just in case).

Protection from the consequences of (main) contractor insolvency

The most effective method of avoiding contractor insolvency is to employ the right contractor. Clients should not be tempted to accept the lowest tender submission on principle. The trading history and financial position of those submitting tenders should be carefully reviewed and a financial risk assessment made.

In addition, a client (or sub-contractor) should be alert to the following, each of which may indicate that a contractor is in financial difficulty:

- The contractor's employees not turning up for work or a general decrease in the amount of labour on site.
- A slow-down in progress of the works.
- Plant, equipment and materials "disappearing" from site.
- An increase in the number of defects to the works.

[27] [1978] 1 All ER 1976

- The contractor seeking to negotiate further payments or release of the retention, or any other change in payment patterns (such as an advance payment or more frequent instalments or certificates).

- The contractor raising spurious or unjustified claims or contra-charges to increase the amount payable to it.

- The contractor assigning (or seeking the client's consent to assign) the proceeds of the building contract to a bank or other creditor.

- If the contractor is a company, late filing of accounts or annual returns at Companies House or auditor's reports that are signed off subject to a qualification (depending on the nature of the qualification).

- Unsatisfied court judgments against the contractor. These may be revealed by a business information report on the contractor from a specialist business information provider, such as Dun & Bradstreet.

- Sub-contractors not being paid.

- Persistent rumours about the contractor's financial position in the press and from other sources.

- An underlying trend in the contractor's behaviour that suggests it is in financial difficulty.

- The contractor's parent company (or other companies in the same group as the contractor) displaying any of the warning signs listed in this note.

If the client is concerned that the contractor is "struggling" financially, the first port of call should be to enter into dialogue with the contractor to establish whether or not its concerns are founded. If this is not possible, the client should consider what rights it has under the contract in order to ensure that it does not fall victim to contractor insolvency.

Outlined below are a number of contractual and extra-contractual ways in which a client can mitigate the impact of contractor insolvency:

A project bank account: Whilst not mandatory, where public funding has been secured, clients are reminded that the OGC advocates the use of project bank accounts, and has provided a detailed guidance note on the matter.[28] It is not unusual for clients to have reservations about using a project bank account because of the increased administrative burden and additional cost.

However, if the contractor becomes insolvent, the project bank account provides the client with a useful safety net, safeguarding funds meant for the contractor's sub-contractors and suppliers, which would otherwise be swallowed up in the contractor's bank accounts (the project bank account will need to create a trust: see Re Tout and Finch.[29] This may assist the client if it needs the sub-contractors' and suppliers' co-operation to complete the project.

Weighted stage payments: so that payments to the contractor are "back-loaded", with less payable at the start of the project and more as it nears completion. Weighted payments are often commercially unattractive to a contractor, as it will have to finance the project. In

[28] Guide to Best Fair Payment Practices, September 2007
[29] [1954] WLR 178).

order to pay for the cost of that finance, the contractor may have to increase its price. This, in turn, may make weighted payments less attractive to the clients.

Enhancements to contract terms

In addition to the above, the client might consider taking further action and making further provision in its capital works contract to protect itself from contractor insolvency. Such actions/provisions might include:

(1) Under the Housing Grants Construction and Regeneration Act 1996 (as amended by the LDEDC 2009), unless a valid pay less notice is served on the contractor within the prescribed period before the final date for payment, the client must make the relevant payment to the contractor. Contracts can provide that, as from the date of the contractor's insolvency, the client is relieved from making any further payments that would otherwise be due under the contract.

The House of Lords has held that such wording in the 1998 editions of the suite of JCT standard building contracts meant that a client did not have to make further payment to an insolvent contractor, even though the appropriate withholding ("pay less") notice had not been served in accordance with the 1996 Act *(Melville Dundas Ltd v George Wimpey UK*[30]*)*.

The JCT 2005 provides that "other provisions of this Contract which require any further payment or any release of Retention shall cease to apply". They also allow the client to use the unpaid sums (retention) to complete the works and only account to the contractor for any unused amounts. While this gives the client much needed relief, there is a risk of double payment (see below) if the client uses the money to pay subcontractors for work carried out before termination of the contractor's employment.

(2) To minimise any delay as a result of the insolvency of the contract, it may be in the best interests of the client to retain the subcontractors and enter into direct contract with them for the remainder of the works. It is highly likely that the subcontractors will be seeking payment of any outstanding sums for work previously carried out under the invoice, whilst this may increase the risk of double payment (i.e. having to pay both the contractor and the subcontractor for the same works), it may still be in the interest of the client to "do a deal" in order to ensure that the works are completed on time.

(3) A provision to allow the client to complete the project using an alternative contractor and recoup the cost of doing so from the original insolvent contractor, or more likely, off-set the cost against sums owed under the contract.

(4) A provision to allow the client to make direct payments to sub-contractors and suppliers, subject to careful drafting to:

- Ensure that the client's liability to the contractor reduces by an amount equal to any direct payment the client makes to a sub-contractor, supplier or professional consultant. The client should also ensure that, before the client makes a direct payment, the recipient indemnifies the client against any liability the client might have to pay the same amount to the contractor; and

- Avoid falling foul of the pari passu rule on insolvency. The pari passu principle is one of the most fundamental principles of insolvency law, and means that all

[30] [2007] UKHL 18

unsecured creditors in an *administration* or a *liquidation* must share equally any available assets of the company, or any proceeds from the sale of any of those assets, in proportion to the debts due to each creditor.

(5) The client might consider a vesting certificate, in order to secure rights over off-site materials, or at least a bond to secure any payment made in respect of such materials.

- A vesting certificate is confirmation from one party (for example, a contractor) to another (for example, a client) that, when the client pays the contractor for goods or materials (which the contractor has not yet delivered to the client/ the site), they will become the client's property. That is, they will "vest" in the client on payment.

- While vesting certificates can be useful, they are not always effective. For example, if a client has a vesting certificate from a contractor who is on the brink of insolvency, and goods referred to in a vesting certificate "disappear" from a warehouse, while that disappearance may (or may not) be a theft of the client's property, the certificate itself is unlikely to help the client.

(6) Both at common law and under the majority of standard building contracts, the client has a right to enter the site to secure the project and any plant, equipment and materials on the site. (If the contractor goes into administration, the client's right may be subject to a statutory moratorium on creditor action (*paragraphs 42 and 43, Schedule B1, Insolvency Act 1986*). However title to materials which has yet to pass to the contractor, from either a supplier or subcontractor, cannot pass to the client. In order to avoid this situation occurring, clients should ensure that subcontracts are procured back to back with the contractors own contract, and that no retention of title clauses are incorporated into either the contract or any corresponding subcontracts.

(7) The right to take possession of any plant, equipment and unfixed materials on site sell them and apply the proceeds towards satisfying the contractor's debts under the building contract. The client may want to use plant, equipment and unfixed materials to complete the works before selling it and the building contract may also permit this. The client should consider registering its rights over the plant, equipment and unfixed materials as a floating charge in order to avoid the contractor's insolvency practitioner having a claim over them. If the client decides to register a floating charge, it should do so as soon as possible, as a floating charge may be avoided if it is registered in the six months before a contractor goes insolvent (*section 245, Insolvency Act 1986*).

(8) Likewise, the client should resist inclusion of any clause restricting or suspending his right to copy and use the design documents.

Julie Stagg, Partner
Fenwick Elliott
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