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PAYMENT, ABATEMENT AND SET-OFF

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ASSOCIATION OF INDEPENDENT CONSTRUCTION ADJUDICATORS ANNUAL CONFERENCE

Payment rules and notices - introduction

1. "The Housing Grants Construction and Regeneration Act 1996 (and the Statutory Instrument made under it) constitutes a remarkable (and possibly unique) intervention in very carefully selected parts of the construction industry whereby the ordinary freedom of contract between commercial parties (without regard to bargaining power) to regulate their relationships has been overridden in a number of areas …" (His Honour Judge Humphrey LLoyd QC in *Outwing Construction Limited* v *H Randell & Son Limited* [1999] 15 Constr LJ Vol.3).

2. The Housing Grants, Construction and Regeneration Act 1996 (HGCRA) not only introduced adjudication, but also introduced new payment rules and notices, which are now mirrored (although not always accurately) in all standard forms of construction contracts and professional appointments and must also be included in bespoke contracts.

3. The Act has now been in operation for over six years, and it has, as several legal columnists have written, worked very well. The courts, led by Mr Justice Dyson's seminal judgment in *Macob* v *Morrison* – the first judicial pronouncement on the enforcement of an adjudicator's decision – have resolutely backed the intentions of Parliament, even though they felt uneasy with the implications of speedy adjudication.

4. Change is however upon us. A review is in process set in train by the Chancellor in the last budget, to reduce payment times still further. Sir Michael Latham leads it

under the Construction Minister, Nigel Griffiths. A pan-industry Review Group has been established by the DTI with two Working Groups established to advise the Review Group on scope and matters detailed for consultation[(1)]. These groups are seeing if there are aspects that need changing in the light of experience and some recent court judgments. I can reveal there was very little consensus in the recent Payment Groups submission[(2)] despite numerous meetings and there is a month's slippage in the overall programme with a consultation paper now due November with responses due thereto by the end of the year[(3)]. I must stress that this is not Latham Mark II akin to Latham's original "Constructing the Team" in 1994. It is planned that the detailed mechanisms for implementation will then be prepared and handed over to the Government for implementation at the end of March 2005. We shall see.

5. It is impossible to predict with any certainty what the results of Sir Michael's review of the Act and its subordinate legislation, the Scheme for Construction Contracts, will be. It is, however, relatively straightforward to pinpoint the issues which will be under scrutiny by the Review Group over the next ten months or so[(4)].

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(1) Being the CUB (Construction Umbrella Bodies Adjudication Task Group) under Graham Watts and the Payment Working Group under Richard Haryott

(2) I understand however that things that are agreed are: the need to improve the right to suspend performance in cases of non-payment; the limiting of the right of cross-contract set-off; to clarify the definition of "adequate mechanism".

(3) The legislative change will be via a vehicle called a Regulatory Reform Order Procedure.

(4) In general terms there is no doubt Adjudication has been exceptionally well received by the industry. Statistics produced by Glasgow Caledonian University's Adjudication Reporting Centre show that around 2000 Adjudicators are nominated by Adjudicator Nominating Bodies each year. Of all of the disputes which go to Adjudication, only a fraction end up in court and an even smaller fraction end up in a successful challenge to the decision. There is self-evidently no fundamental flaw in Adjudication which requires fixing. In a response to the December 2000 review by the CIB, the DTI (then DETR) explained that any review of the Act should be directed towards making it more effective and not reopen the compromises that underlay its drafting.
Unless Sir Michael disagrees with this policy it is unlikely we will see any fundamental changes in approach through the present review. Nevertheless, there is always room for improvement and the following paragraphs highlight some areas where improvements might be made.

Payment
In stark contrast to Adjudication, there has been rather less comment on the payment provisions of the Act and the Scheme.

"Pay when paid"
In their letter to the Construction Minister of September 2003, the Society of Construction Law stated that "notwithstanding the payment provisions of the Housing Grants, Construction and Regeneration Act 1996… lengthy payment periods and delays in payments continue severely to damage construction business…Many contractors currently impose unreasonably long payment periods on their sub-contractors, partly perhaps to buy themselves time to pay in the absence of being able to rely on pay when paid arrangements."
The Society concluded that this area should be reviewed in the light of current attempts to get round the ban on "pay when paid", for example by the use of "pay when certified" clauses.
The ban on "pay when paid" does not currently apply when the third party (who is to make payment before the next party gets paid) is insolvent. This has been the subject of calls for review and it is difficult to see why this should not be changed. It is precisely when there is an insolvency at the top of the chain that those at the bottom of the chain will suffer most, unless they have the benefit of statutory protection.

Notices
The review could usefully clarify the effect of failure to serve a "payment notice" under section 110 of the Act (if any) and the circumstances in which a "withholding notice" under section 111 is required.

The legislation

6. To the law we go. The relevant sections of the HGCRA relating to payment and payment notices are as follows:

6.1 Section 109 – Entitlement to stage payments

> "(1) A party to a construction contract is entitled to payment by instalments, stage payments or other periodic payments for any work under the contract unless –
>
> (a) it is specified in the contract that the duration of the work is to be less than 45 days[5], or
>
> (b) it is agreed between the parties that the duration of the work is estimated to be less than 45 days.
>
> (2) The parties are free to agree the amounts of the payments and the intervals at which, or circumstances in which, they become due.
>
> (3) In the absence of such agreement, the relevant provisions of the Scheme for Construction Contracts apply."

6.2 Section 110 – Dates for payment

> (1) Every construction contract shall
>
> (a) provide an adequate mechanism for determining what payment becomes due under the contract, and when, and
>
> (b) provide for a final date for payment in relation to any sum which becomes due.
>
> The parties are free to agree how long the period is to be between the date on which a sum becomes due and the final date for payment.

[5] When calculating the duration of the work, Christmas Day, Good Friday or other bank holidays should not be included but weekends are included within the 45-day period. The same method of calculation should be adopted when determining notice periods under the Scheme.

(2) Every construction contract shall provide for the giving of notice by a party not later than 5 days after the date on which a payment becomes due from him under the contract, or would have become due if

(a) the other party had carried out his obligations under the contract, and

(b) no set-off or abatement was permitted by reference to any sum claimed to be due under one or more other contracts,

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

(3) If or to the extent that a contract does not contain such provision as is mentioned in subsection (1) or (2), the relevant provisions of the Scheme for Construction Contracts apply.

6.3 Section 111 – Notice of intention to withhold payment

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

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

(2) To be effective such a notice must specify

(a) the amount proposed to be withheld and the ground for withholding payment, or

(b) if there is more than one ground, each ground and the amount attributable to it, and must be given not later than the prescribed period before the final date for payment.

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

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

6.4 Section 112 – The right to suspend performance for non-payment

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

(2) The right may not be exercised without first giving in writing to the party in default at least 7 days' notice of intention to suspend performance, stating the ground or grounds on which it is intended to suspend performance.

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

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

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

6.5 A "construction contract" is defined in section 104 as

(1) …an agreement with a person for any of the following

(a) the carrying out of construction operations;

(b) arranging for the carrying out of construction operations by others, whether under sub-contract to him or otherwise.

(c) providing his own labour, or the labour of others, for the carrying out of construction operations.

(2) References … to a construction contract include an agreement

(a) to do architectural, design or surveying work, or

(b) to provide advice on building, engineering, interior or exterior decoration or on the laying out of landscape,

in relation to construction operations.

6.6 Section 105 defines "construction operations" as meaning

(a) Construction, alteration, repair, maintenance, extension, demolition or dismantling of buildings or structures forming or to form part of the land (whether permanent or not)…

(b) …

(c) Installation in any building or structure of fittings forming part of the land, including…systems of heating, lighting, air conditioning, ventilation, power supply, drainage, sanitation, water supply or fire protection, or security or communications systems.

(d) External or internal cleaning of buildings and structures, so far as carried out in the course of their construction, alteration, repair, extension or restoration…

(e) …

(f) Painting or decorating the internal or external surfaces of any building or structure.

6.7 Sections 109 to 112 therefore apply to the vast majority of construction contracts and professional appointments; it is vitally important to be aware of them and the consequences of failure to comply with their requirements. Many people still do not realise the very wide scope of the HGCRA and the broad range of contracts it covers.

6.8 These provisions only apply where the "construction operations" are carried out in the United Kingdom.

6.9 It is the location of the "construction operations" which is important, and, consequently, the payment provisions would not apply to a construction contract, which states that the law of the contract is English but the construction work is to be carried out in mainland Europe. The provisions of the Act would, however, apply to a construction contract, which specifies the law of the contract for example is to be

Dutch but the actual work is to be carried out in the UK, a not-uncommon situation with construction work at docks or harbours. It is also not uncommon for UK architects to be commissioned by foreign clients for buildings which are to be built abroad. The architectural and design work which is carried out in the UK under such a commission would not be covered by the Act as architectural and design work does not come within the definition of "construction operations" if the actual building work is to be carried out abroad.

It is also important to note that you *cannot* contract out of these provisions.

There has now been a considerable amount of case law on the requirements for the service of notices under sections 110 and 111 (and their corresponding requirements in paragraphs 9 and 10 of the Scheme for Construction Contracts, which will apply in the event of the construction contract itself not covering the statutory obligations). These requirements are central to the objectives enshrined in the HGCRA to provide, if not security for payment, then at least greater certainty of payment and control over the withholding of monies for work done.

For the purposes of this paper, the notice required by section 110(2) is described as a "payment notice" and the notice required by section 111 as a "withholding notice".

"Due" date and "Final date for payment"

7. In looking at the notice requirements contained in section 110(2) and Section 111, it is essential to have in mind the important distinction between the "due" date for payment and the "final date for payment" which is made for the purposes of the payment provisions generally. These concepts are clearly central to the HGCRA. Unfortunately, neither term is defined in the legislation. However, section 110(1)(a) requires that every construction contract shall provide an "adequate mechanism" for determining what payments become "due" under the contract, and when; and section 110(1)(b) provides a similar requirement for a "final date for payment" in relation to any sum which becomes "due". It is to the particular contract that you must therefore look in order to identify when monies become "due" under the contract. In the case of the standard forms of main contract, this normally involves a process of evaluation or ascertainment by a third party, normally an independent contract administrator, and the "due" date for payment will usually be the date of issue by that third party of a payment certificate or valuation. This process involves a gross valuation, from which amounts previously paid should be deducted in order to

arrive at the amount "due" for payment[6]. However, in the case of the JCT With Contractors Design 1998 form, which does not involve such a procedure, the "due" date for payment is the date on which the Employer receives an application for payment from the Contractor[7]. In professional appointment forms, the "due" date is normally the date of issue, alternatively, the date of receipt, of the consultant's invoice[8].

7.1 It is generally accepted that the purpose of the requirement for a payment notice is to ensure that the payee knows at a relatively early stage of the payment cycle the amount which he can actually expect to receive, together with the basis on which that amount is calculated. By giving the payee that knowledge, he should then be in a position to start adjudication proceedings to challenge the assessment of the amount "due" relatively quickly, if he disagrees with what is in the payment notice.

7.2 It is standard practice in the construction industry to allow the paying party a stated period after the "due" date within which the payment is to be made. The last date for payment without the paying party falling into breach of contract is referred to as the "final date". This date is particularly important for two reasons. Firstly, the statutory right of the payee to suspend performance of the works for non-payment crystallises after the "final date", if payment is not made by then. Secondly, it serves as a reference point for determining whether the paying party has served a withholding notice on time (see below).

7.3 The JCT Standard Form of Building Contract, 1998 Edition (JCT 98)

Clauses 30.1.1.1 and 30.1.3 of JCT 98 together specify dates when the Architect is to issue to the Employer Interim Certificates stating the amount then "due" to the Contractor. The date of issue of an Interim Certificate is therefore the "due" date for payment of the amount stated in it. Clause 30.1.1.1 states that the final date for payment of an Interim Certificate is 14 days after its issue.

Clause 30.8.1 provides that the Final Certificate is to be issued within 2 months of whichever of these occurs last: (i) the end of the Defects Liability Period, (ii) the date of issue of the Certificate of Completion of Making Good Defects, (iii) the date on which the Architect sent copies of the final accounts to the Contractor and Nominated Sub-Contractors. The final date for payment of any amount "due" to the

[6] See Clause 30.2, JCT 98, Private With Quantities Edition.
[7] See Clause 30.3.3, JCT 98.
[8] See Condition 39, (1.39) GC/Works/5

Contractor under the Final Certificate is 28 days from the date of issue of the Certificate.

7.4 The JCT Standard Form of Building Contract With Contractor's Design (WCD 98)

WCD 98 requires the Employer to serve a payment notice within 5 days of receipt of the Contractor's payment application. Where such notice is served the Employer is to pay the amount in the notice (subject to any withholding notice). However, where no such notice is served, Clause 30.3.5 requires the Employer to pay the *full* amount of the Contractor's application (again, subject to any withholding notice). The final date for payment in either case is 14 days after receipt of the payment application.

7.5 GC/Works/5 (1998) and (1999)

General Condition 39 (1998 form)/1.39 (1999 form) provides for the Employer to pay the Consultant within 30 days of the Employer's receipt of the Consultant's valid invoice.

Although the wording of this clause is not as clear as it might be, the date of receipt by the Employer of the Consultant's valid invoice is regarded as the "due" date for payment of the amount stated in it, and the payment notice specifying the amount (if any) of the payment made or proposed to be made, and the basis on which that amount is calculated, must be given not later than 5 days after receipt of the invoice.

It is therefore very important always to have an accurate record of when an invoice has been received and to put necessary systems in place to ensure that as soon as an invoice has been received, this is made known to any others involved in the project who will be issuing the requisite payment/withholding notices.

The final date for payment of the amount "due" (subject to any withholding notice) is 30 days from receipt of the invoice.

Payment notice requirements

8. Section 110(2) HGCRA provides that every construction contract must require the party for whom the work is done to serve a notice not later than 5 days after the "due" date for payment. The notice must state the amount that the paying party has made or proposes to make *and* the basis of its calculation. In terms of content, it is designed to expose, very early, any differences between the parties regarding the

amount "due" and its make-up for resolution, failing which either party may refer the difference(s) to adjudication.

Withholding notice requirements

9. The key requirements of the withholding notice are important to note, as the paying party will be treated as having failed to serve it if any of them is not met. They are:

- the notice *must* be served within the applicable time period;
- its content *must* be detailed, as required by sub-section 111(2), setting out the amount(s) to be withheld and the ground(s) for so doing;
- it *must* be in writing.

The most common grounds for the withholding of monies include:-

- liquidated and ascertained damages for delay;
- the cost of remedying defective work;
- previous overpayment;
- sums owed on other contracts;
- damages for breach of contract.

These are often given a variety of confusing descriptions, including abatement, set-off and counter-claim: see section 24 below.

It has been established by case law that the withholding notice *must* be in writing. A withholding notice served prior to the payment application to which the withholding notice relates is not effective notice for the purposes of section 111. Ringing up on the day you receive the application for payment and referring to an earlier letter concerning the account is not good enough.[9]

Period for service of withholding notice

10. Section 111(3) provides that the parties are free to agree the period for serving the withholding notice and that, in the absence of such agreement, the relevant period provided in the Scheme applies. Paragraph 10 of Part II of the Schemes states that the latest date for service of the notice is 7 days before the applicable final date for payment. The latest dates for the main standard forms are:

JCT 98:	not later than 5 days before the final date for payment
WCD 98:	not later than 5 days before the final date for payment
GC/Works/5 1998:	not later than 7 days before the final date for payment
GC/Works/5 1999:	not later than 7 days before the final date for payment

See section 7 above for the definitions of "final date for payment" in these forms.

Adequate mechanism for payment

11. All construction contracts must have an "adequate mechanism" for establishing what payment is due and when.[10] No guidance is given as to what is a "adequate mechanism" but it is believed that most of the existing standard forms (probably) comply with the Act. (11)

    It is however questionable as to whether a paid when certified arrangement(12) constitutes an "adequate mechanism".

    The Act lays down a set of payment terms that a construction contract must contain.

12. Quite what constitutes an "adequate mechanism" under section 110(1)(a) is unclear. Lord MacFadyen in *Maxi Construction Management Limited* v *Mortons Rolls Limited* (7 August 2001) gave some consideration to this issue. The contractor, Maxi Construction, contended that they were entitled to an interim payment in respect of application no. 10. There was some debate about which terms had been incorporated into the contract, and ultimately the decision turned upon the nature of the contractor's submission for payment. The contract in question required the employer's agent to agree the valuation with the contractor before making a claim for payment. There was no obligation on the employer's agent to agree a valuation within a clear timescale. As this effectively meant that claim for payment could be

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(9) *Strathmore Building Services Ltd* v *Colin Scott Greig*

(10) Section 110(1) of the Act.

(11) It is interesting to observe the Hansard debate at the time on 26 February 1996: "The noble Lord, Lord Berkeley, said that lawyers will have a field-day in relation to what constitutes an 'adequate mechanism' for payment. The industry covers thousands of different operations and dozens of different types of contract. Payment is already determined in far too many ways for us to come up with a single definition. This legislation requires that payment should be defined in terms of amount and date. That will be a big improvement on what happens at the moment…"

(12) Pay-when-certified arrangements are commonplace. The Constructors Liaison Group questionnaire survey in 1999 revealed that 63 per cent of contracts made payment conditional on some activity higher up the contractual chain such as the issue of a main contract certificate. Another variant makes entitlement to payment dependent upon the valuation of sub-contract work being included in a main contract valuation. Domestic sub-contractors in such set-up have no entitlement to be advised when, or if, a certificate is to be issued under the main contract or any effective means of finding out. Furthermore, certificates issued under the main contract will not identify the amount due to them since their prices will not be known to the certifier. They cannot, therefore, establish when or what payment becomes due and cannot, in consequence, operate remedies for non-payment such as the statutory right of suspension.

delayed indefinitely, Lord MacFadyen held that it was an inadequate mechanism. A payment provision that does not provide a clear timescale for dealing with and resolving payment issues is therefore inadequate, but Lord MacFadyen does not offer any guidance as to a test which could be applied in order to determine whether a payment mechanism is adequate or inadequate.

13. It is noteworthy the Latham II Payment Group could not reach consensus on what was an adequate mechanism.

Date Payment Due

14. The parties to a construction contract are free to agree how payments are calculated, the intervals and circumstances in which payments are to be made. This can be either the usual monthly valuation periods or stage payments.

14.1 If there is no agreement: - the relevant period for calculating payments will be 28 days; and payment becomes due on the date of application or 7 days after the end of the period (whichever is the later!).

At the risk of repeating myself this does not mean that payment has to be made on the date payment is due, rather this date triggers the various time limits for notices to be served. [13]

Notice of payment

15. Not later than 5 days after the date for payment is due, the paying party must state the amount that he proposes to pay. [14] The notice of payment should still be given even if you do not intend to make any payment at all (because of a cross-claim or some other deduction).

What happens if a notice of payment is not served?

16. In nearly all cases nothing. The Act does not say what happens if a Notice of Payment is not served. However, the Act does not make any provision for a failure to issue such a payment notice. Duncan Wallace QC considers that the absence of any sanction is a significant lacuna in the legislation, which leads him to question the

[13] Sections 109(2) and (3) of the Act.
[14] Section 110(2) of the Act.

legislative intention in requiring such a notice. [15] The absence of any sanction has also been commented upon by Lord MacFadyen in the case of *SL Timber Systems Limited* v *Carillion Construction Limited* [2001] BLR 516: "Section 111(1), unlike section 110(2), did impose a sanction for failure to serve a notice…"[16] and then again at paragraph 19:

> In my opinion the adjudicator fell into error in the first place by conflating his consideration of section 110 and 111 of the 1996 Act. In my opinion Mr Howie was correct in his submissions that these sections have different effects and the notice which they contemplate have different purposes. Section 110(2) prescribes a provision which every construction contract must contain. Section 110(3) deals with the case of a construction contract that does not contain the provision required by section 110(2) by making applicable in that case the relevant provision of the Scheme, namely paragraph 9 of Part II. By one or other of these routes every construction contract will require the giving of the sort of notice contemplated in section 110(2). But there the matter stops. Section 110 makes no provision as to the consequence of failure to give the notice it contemplates. For the purposes of the present case, the important point is that there is no provision that failure to give a section 110(2) notice has any effect on the right of the party who has so failed to dispute the claims of the other party. A section 110(2) notice may, it if complies with the requirements of section 111, serve as a section 111 notice (section 111(1)). But that does not alter the fact that failure to give a section 110(2) notice does not, in any way or to any extent, preclude dispute about the sum claimed. In so far, therefore, as the adjudicator lumped together the defenders' failure to give a section 110(2) notice with their failure to give a timeous section 111 notice, I am of opinion that he fell into error. He ought properly to have held that their failure to give a section 110(2) notice was irrelevant to the question of the scope for dispute about the pursuer's claims.

17. This is of interest as some had thought that the absence of a section 110(2) notice meant that the claimant (at least in an adjudication) was relieved of the usual burden of proving entitlement and should be awarded the sum claimed.

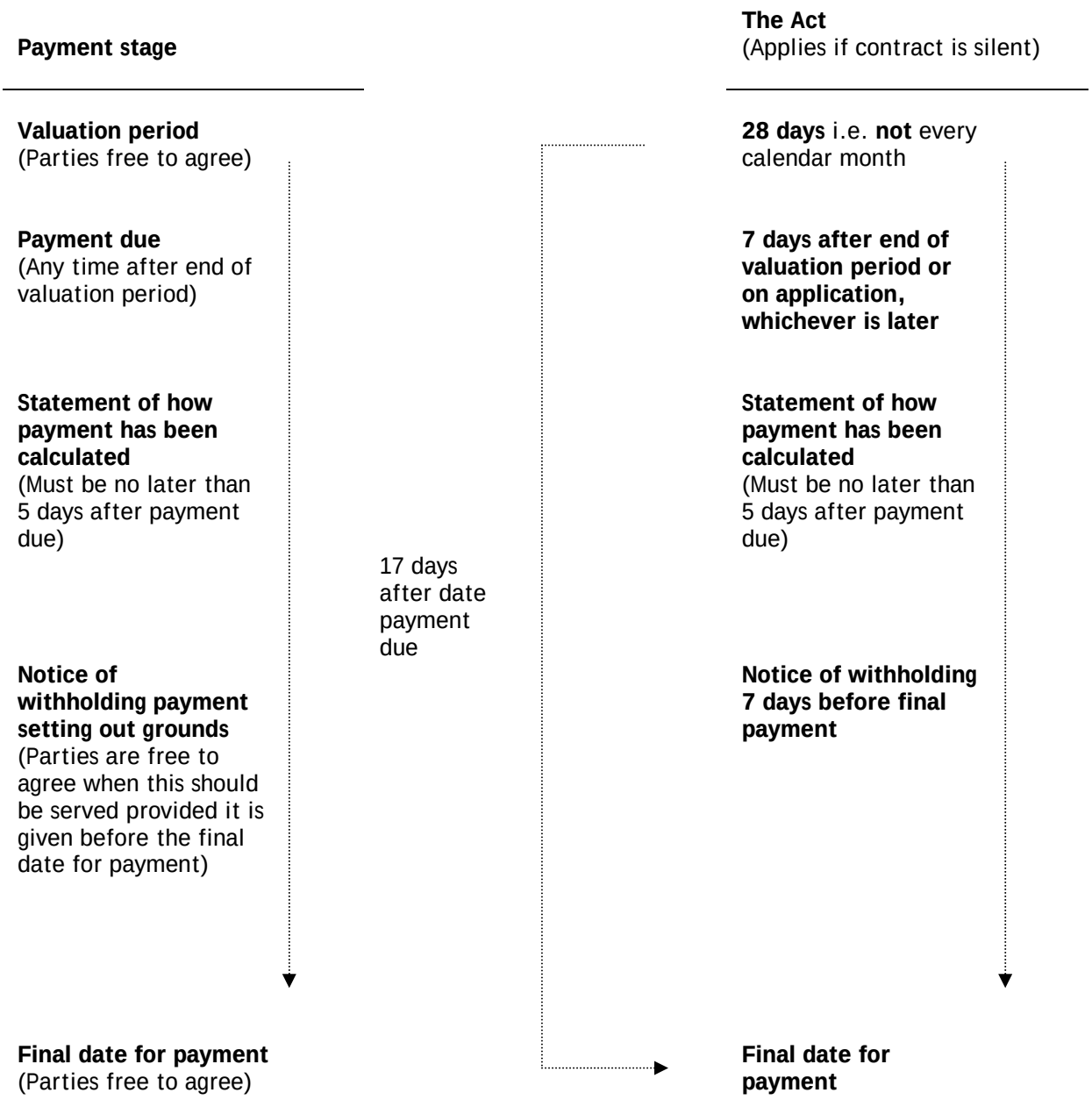
[15] Wallace, I.N.D. QC (2002) "The HGCRA: A Critical Lacuna?" 18 Const. L J 2, page 117
[16] Para.14

So what happens if I do nothing, how does the Scheme invoke payment?

Answer:

The Housing Grants, Construction and Regeneration Act 1996

Payment Scheme



Withholding notice

18. A party cannot withhold payment after the final date for payment, unless they serve a withholding notice.[17]

19. The withholding notice must state: -

19.1 the amount which will be withheld and the grounds for withholding; and

19.2 if there is more than one, each ground and the amount which is attributable to each.[18]

20. Save that it must be served before the final date for payment the parties are free to agree the date when the withholding notice is served.[19] If there is no agreement the Scheme again cuts in[20] and a withholding notice must be served at least 7 days before the date for final payment.[21]

Final date of payment

21. The parties can agree the final date for payment (i.e. the day when the monies are actually paid). If no agreement is reached this will be 17 days from the date payment was due.

If a notice to withhold payment is not served, is the contractor entitled to the sum applied for?

22. It would be fanciful to suggest that, in the absence of a withholding notice, the contractor is entitled to the full amount of the application, whatever that may be. (However, this is the approach taken by JCT WCD 1998, the design and build form of contract.[22]

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[17] Section 111(1) of the Act.

[18] Section 111(2) of the Act.

[19] Section 111(3) of the Act.

[20] In *Hills Electrical & Mechanical plc* v *Dawn Construction Ltd* (2003), the Court held that where a contract fails to provide payment terms in accordance with the requirements of the Construction Act, it is only the relevant provisions of the Scheme which will be imported into the subcontract in order to rectify the deficient term as under the HGCR Act 1996, there must be an adequate mechanism for determining when payments become due, what is to be paid and the final date for payment. Should a contract fail to provide for all or any of the mandatory payment provisions, then the Scheme for Construction Contracts (the Scheme) will imply such terms.

[21] Paragraph 10 of the Act's Scheme.

[22] See: *M J Gleeson Group plc* v *Devonshire Green Holding Ltd* (2004) following earlier case of *VHE Construction Plc* v *RBSTB Trust Company Ltd* (2000);

The position as to what the party is entitled to in the absence of a withholding notice is not entirely clear in England. However, the position is probably: the absence of a withholding notice will prevent the other party from setting off his own claims against payment; however it will not usually prevent an abatement e.g. the employer denying that the amount in the application is actually due but see *Rupert Morgan Building Services Ltd* v *David Jervis and Harriet Jervis*.

Paid when paid clauses

23. Paid when paid clauses have been outlawed save that, a paid when paid clause can still operate if the main contractor or any other third party upon whom the payment is dependent (such as the ultimate Employer) becomes insolvent. [(23)]

Abatement/Set-off: what are they and do they matter?

24. In order to understand which grounds for non-payment do require protection by a valid withholding notice and which grounds do not, it is necessary to look at, and distinguish between, the concepts of "abatement" and "set-off".

25. The common law right of abatement is a defence which is generally limited to contracts for sale of goods or for work and materials and can be invoked by a defendant to reduce the value of goods and services supplied by the claimant where, for some reason, the goods and services in fact supplied did not justify the payment of the full agreed price by the defendant. So it means the right of the person for whom work is carried out to reduce the price which he has agreed to pay, usually because the work has not been done properly, or has not been completed. It is a means of adjusting the sum payable, rather than requiring a separate cross-claim to be brought. Accordingly, abatement goes to the question of what amount becomes "due" under the contract and should be considered when preparing the payment notice but not necessarily a withholding notice.

26. Conversely, set-off does not relate to the amount which the supplier is entitled to be paid for the work which he has done, but refers to an entirely separate right which accrues to the purchaser through the supply of what was contracted for, which relates not to the value of what was supplied but, instead, to the consequences of the manner in which it was performed. An essential prerequisite for a right of set-off is that the supplier has committed a breach of contract entitling the purchaser to

[(23)] Section 113 is intended to curb the widespread practice of making a sub-contractor's entitlement to payment dependent on the contractor receiving payment. The section renders ineffective a provision which makes payment conditional upon the payer receiving payment from a third party unless the third party is insolvent.

damages. An obvious example of this is a claim for liquidated and ascertained damages, or even unliquidated damages, for delay.

27. As a matter of principle, abatement involves an argument that goes to the quantification of the sum "due" under the contract, whereas set-off may, if the circumstances exist, constitute a ground for withholding payment of some part of what is "due". It follows that, in terms of payment notices and withholding notices, an abatement should be raised at the valuation stage and, at the latest, at the time the payment notice is required to be given. Conversely, a set-off is not a matter which relates to valuation and the paying party must therefore ensure that it is protected by an effective and valid withholding notice given at the proper time.

28. If a paying party only raises a matter of abatement as late as when it gives its payment notice, this will be too late in the case of contracts which involve a procedure for gross valuation by a third party, involving the issue of a certificate confirming the sum "due" in respect of a particular application. It is in respect of the amount stated in the certificate that withholding of payment falls to be judged rather than against the amount to be included in the payment notice. This was recently confirmed by the Court of Appeal.[24]

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[24] *Rupert Morgan Building Services Ltd* v *David Jervis and Harriet Jervis* [2003] EWCA Civ 1563 where it was found section 111(1) Housing Grants, Construction and Regeneration Act 1996 was a cash-flow provision and operated to prevent clients from withholding sums due, in the absence of a withholding notice. Lord Justice Sedley reflected on the history of such cash-flow problems. Indeed, he said, the very building in which this trial was being heard, the Royal Courts of Justice, got into dreadful problems in 1880 when the contractor, a modest, undercapitalised enterprise, stopped paying the stonemasons because the employer was dilatory in honouring the architect's payments certificates.

The contract, by the way, was the Architecture and Surveying Institute (ASI) Standard Form. The Construction Act says that if an employer wishes to keep its hands on money otherwise due, then it has to send a "withholding notice". This must always be served before the date payment should have been made.

The appeal by defendants ('the clients') was from the decision of HH Judge Anthony Thornton QC giving summary judgment against them in relation to a claim for payment of outstanding sums owed to the claimant ('the builders'). The clients had works done by the builders pursuant to a written contract in a standard form provided by the ('ASI'). Under the ASI contract, the builders were paid on an interim basis and the architect used by the clients was to issue interim certificates. The clients accepted that part of the seventh interim certificate was payable, but disputed an amount of £27,000. The builders argued that, under s.111(1) Housing Grants, Construction and Regeneration Act 1996, the clients could not withhold payment because they had not given a notice of their intention to do so within the prescribed period. They succeeded in obtaining summary judgment on the outstanding sum.

HELD: (1) Section 111(1) of the Act did not say that failure to service a withholding notice created an irrebuttable presumption that the sum was properly payable in the final analysis. The contract therefore had to be looked at to discover how the sum was determined and when it was due. (2) In the ASI contract, the sum was determined by the certificate. It was not the actual work done that defined either the sum or when it was due. (3) In the absence of a withholding notice, s.111(1) operated to prevent clients from withholding sums due. The contractor was entitled to the money straight away. The fundamental thing about s.111(1) was that it was a provision about cash-flow, not one that sought to make any interim or final certificate final. Sheriff Taylor's analysis of s.111(1) in *Clark Contracts* v *The Burrell Co* (2002) SLT 103 was clearly correct.

Consequences of failure to serve the notices

29. The legislation does not state what the consequences of failing to serve a payment notice are or should be. It is intended as a statement of good practice and an early identification of any differences between the parties regarding the quantification of the amount "due". As stated above, some standard forms, such as JCT With Contractors Design 98, go beyond this by providing that if the payment notice is not served, the amount claimed by the contractor becomes the amount "due" and must be paid in full accordingly (subject to any withholding notice).

    Although there is no sanction for failure to serve the Section 110 payment notice, case law has established that it still remains open to the payer, notwithstanding the failure to serve this notice, to dispute the sums claimed by the payee to be "due" (other than in WCD 98). There is often a difference between the amount *claimed* and the amount "*due*" under the contract/appointment.

30. In the early days of the HGCRA, some adjudicators decided that, in the absence of a payment notice, they could treat the amount for which the payee had applied as the amount "due" under the contract. This has now been held to be the incorrect approach. [25]

31. The HGCRA provides for two consequences of failure to serve a withholding notice. Firstly, under Section 111 the paying party "may not withhold payment after the final date for payment of a sum due under the contract". Secondly, Section 112 provides that if the paying party withholds the whole of the amount, or any part of it, beyond the final date without an effective withholding notice, the payee is entitled to suspend performance of its obligations under the contract.

    The absence of a withholding notice does not preclude a dispute about the amount properly "due", which is quite different from a dispute about whether part or all of a sum of money "due" can be withheld.

    If there is a dispute about whether a sum claimed is "due", the claimant must prove that the sum claimed is contractually "due", following the mechanism in the contract to establish the amount; if it does this, then the defendant cannot withhold payment on some separate ground unless it has served a valid withholding notice.

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[25] *SL Timber Systems Ltd* v *Carillion Construction Ltd; Millers Specialist Joinery Company Ltd* v *Nobles Construction Ltd*

The making of the distinction between abatement[26] on the one hand and set-off on the other, and the suggestion that the former is something which falls to be considered at the time a payment notice is given, where the latter is something that should be included in a withholding notice, has been followed by the Courts.[27]

In the case of *SL Timber Systems Ltd v Carillion Construction Ltd* Lord MacFadyen looked at the operation of Sections 110(2) and 111 in detail and said that the Adjudicator had fallen into error "by conflating his consideration of Sections 110 and 111 of the 1996 Act" and failing to recognise their distinct form and purpose. He said "it was unlikely that the legislative intent was to treat the absence of a [Section 110] notice as giving rise, even on a provisional basis, to an entitlement for which there was no contractual foundation". The Adjudicator thus still had to determine the amount "due".

The distinction between the purpose of a payment notice and that of a withholding notice, and the different consequences of a failure to serve them, was commented upon by HHJ Gilliland QC in *Millers Specialist Joinery Company Ltd* v *Nobles Construction Ltd*, where he said:

> The notices under the two sections are however directed to different aspects of a payment. Under Section 110 the Act is directed to making clear what is being paid and how that sum has been calculated, whereas under Section 111 the notice is directed to the amount which is being withheld and the reasons for withholding payment.

It has now clearly been established that if an effective withholding notice is not given in time, the amount "due" under the contract must be paid without deduction. Judicial comment has included the following:

(a) For the temporary striking of balances which are contemplated by the Act, there is to be no dispute about any matter not raised in a notice of intention to withhold payment. Accordingly, in my view, the Adjudicator had no jurisdiction to consider any matter not raised in the notice of intention to withhold payment in this case.[28]

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[26] Abatement, as we have seen, is a party's right to defend a claim for payment by showing that, by reason of the payee's breach of contract, the value of works is less than the sum claimed. The most common example occurs in the JCT valuation clauses where the contractor/sub-contractor is entitled to be paid for the value of work "properly executed". The effect of this phrase is that where the work is not properly executed, i.e. it has defects in it, the payer is entitled to reduce the price paid to take account of the defects. Abatement needs to be differentiated from "set-off". Set-off is a right to deduct, from whatever sums are payable, monies in respect of a claim for damages due to the breach of contract of the payee. It is most commonly used in respect of contra-charges, where the payer has incurred costs which the payee should have paid. It can also be used to set off actual or anticipated (depending on the wording of the contract) loss and expense, liquidated damages and other losses caused by the payee's breach of contract.

[27] *VHE Construction plc* v *RBSTB Trust*

[28] HHJ Bowsher QC in *Northern Developments (Cumbria) Ltd* v *J & J Nichol*

(b) In considering a dispute, an adjudicator will make his own valuation of the claim before him and in doing so, he may abate the claim in respects not mentioned in the notice of intention to withhold payment. But he ought not to look into abatement outside the four corners of the claim unless they have been mentioned in a notice of intention to withhold payment. So, to take a hypothetical example, if there is a dispute about valuation 10, the adjudicate or may make his own valuation of the matters referred to in valuation 10 whether or not they are referred to specifically in a notice of intention to withhold payment. But it would be wrong for him to enquire into an alleged over valuation on valuation 6, whether the paying party alleges abatement or set-off, unless the notice of intention to withhold payment identified that as a matter of dispute.[29]

(c) In my opinion the words "sum due under the contract" cannot be equiparated with the words "sum claimed". The section [Section 111] is not, in my opinion, concerned with every refusal on the part of one party to pay a sum claimed by the other. It is concerned, rather, with the situation where a sum is due under the contract, and the party by whom that sum is due seeks to withhold payment on some separate ground. Much of the discussion of the section in the cases has been concerned with what circumstances involve "withholding" payment and therefore require a notice. Without the benefit of authority, I would have been inclined to say that a dispute about whether the work in respect of which the claim was made had been done, or about whether it was properly measured or valued, or about whether some other event on which a contractual liability to make payment depending had occurred, went to the question of whether the sum claimed was due under the contract, therefore did not involve an attempt to "withhold … a sum due under the contract", and therefore did not require the giving of a notice of intention to withhold payment. On the other hand, where there was no dispute that the work had been done and was correctly measured and valued, or that the other relevant event had occurred, and the party from whom payment was claimed wished to advance some separate ground for withholding the payment, such as a right of retention in respect of a counterclaim, that would constitute an attempt to "withhold … a sum due under the contract", and would require a notice of intention to withhold payment…

In my opinion, the absence of a timeous notice of intention to withhold payment does not relieve the party making the claim of the ordinary burden of showing that he is entitled under the contract to receive the payment he claims. It remains incumbent on the claimant to demonstrate, if the point is disputed, that the sum claimed is contractually due. If he can do that, he is protected, by the absence of a Section 111 notice, from any attempt on the part of the other party to withhold all or part of the sum which is due on the basis that some separate ground justifying that course exists.[30]

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[29] HHJ Bowsher QC in *Whiteways Contractors (Sussex) Ltd* v *Impresa Castelli Construction UK Ltd*

[30] Lord MacFadyen in *SL Timber Systems Ltd* v *Carillion Construction Ltd*

(d) If it were correct that the effect of a failure to serve a valid notice of intention to withhold payment under Section 111 was that the amount of the valuation or invoice was to be regarded as a sum "due under the contract", the consequence would appear to be that neither an adjudicator nor the court could properly refuse to order payment in full even though it might be perfectly clear for example that the work or the materials claimed for had not been carried out or supplied, or that the wrong rate or price had been claimed or that there had been some other error in the invoice or valuation.[31]

32. If in any doubt as to whether or not a claim forms an abatement or a set-off, it is sensible to serve a withholding notice in respect of that claim, to be on the safe side.

33. It should be noted that a payment notice can double as a withholding notice, provided that it complies with the requirements of Section 111 as well as Section 110.

Section 112 – The right to suspend performance for non-payment

34. The only express remedy for failure to comply with the payment provisions contained in the legislation is the right of the payee to suspend performance of his obligations under the contract, which arises if:

34.1 a sum "due" under the contract is not paid in full by the final date for payment; and

34.2 no effective withholding notice has been given.

35. In those circumstances, the right to suspend will arise. However, subsection (2) provides that such right can only be exercised if the party intending to do so gives to the other party at least 7 days' notice[32] in which he specifies the ground or grounds for suspension.

36. It should be noted that the right to suspend will only arise in respect of the non-payment of a sum "due" under the contract. This is consistent with the wording used throughout the payment provisions as a whole. It follows that considerable care should be taken to ensure that the particular amount upon which the party is relying is indeed "due". It is insufficient that the money has been applied for and not paid. The failure by the paying party to serve a Section 110 notice will not make the amount applied for "due" save where the conditions of contract so provide.

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[31] HHJ Gilliland QC in *Millers Specialist Joinery Company Ltd* v *Nobles Construction Ltd*

[32] Such a notice must be in writing: see section 115(6).

37. Clearly, a suspension in circumstances where the particular amount has not in fact become "due" would be a wrongful suspension disentitling the suspending party from any ancillary rights to extension of time and/or loss and expense. Furthermore, suspension in those circumstances would certainly amount to a breach of contract entitling the other party to damages and is likely to constitute grounds for determination of the contract.

38. It is clear that part payment of an amount "due" under the contract is insufficient to disentitle a payee from the right to suspend. If the wording in subsection (1) does not put that beyond doubt, subsection (3) does.

39. The fact that the suspending party can suspend performance of "his obligations", rather than simply "the execution or carrying out of the works" is significant. Where the works are complete, this expression would clearly extend to performance of any obligations under the defects liability period. Whether, however, it would extend to any obligation undertaken pursuant to a collateral warranty agreement or guarantee is unclear. Subject to the precise wording of the document, in principle the right to suspend should not apply in respect of obligations which arise under a warranty or guarantee rather than the underlying contract itself.

40. The compensation to which the suspending party is entitled under the legislation in the event of a legitimate suspension is not generous. Subsection (4) simply confirms that the suspending party is entitled to an extension of time for completion of the works covering the period during which performance is suspended. That extension would not necessarily extend to the 7-day notice period prior to the right to suspend becoming operative. That is perhaps understandable but nor will it apply to the time which it takes to re-mobilise following the suspension. This is important since the right to suspend ceases on payment of the amount "due" in full.

    There is nothing to prevent the parties from conferring more extensive rights through the terms of the contract than the legislation provides. By way of example, the JCT With Contractor's Design 98 form entitles the contractor to apply for both extensions of time in respect of "delay arising from a suspension…"[33] and for "loss and expense where appropriate, provided the suspension was not frivolous or vexatious.[34]" Such rights are clearly considerably more extensive than those proposed by the legislation.

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[33] See the JCT with contractor's design form 1998 edition, clause 25.4.17.
[34] See the JCT with contractor's design form 1998 edition, clause 26.2.9.

Drawing the strings together on payment

41. The requirement for service of a payment notice is administrative and/or designed to alert the payee to an impending/actual dispute over the amount "due".

42. Of fundamental importance to both Sections 110 and 111 is the concept of the sum "due" under the contract, which is to be determined by reference to the relevant contract terms.

43. Matters of abatement relating to the amount claimed by the payee go to the sum "due" under the contract and should be recorded in the payment notice. It is not generally felt that they need to be covered by a withholding notice, although some consider it to be safe practice to do so.

44. Matters of set-off and/or an abatement relating to an overpayment on a previous interim valuation should not be treated as matters which go to the sum "due" under the contract in respect of the particular claim for money under a subsequent application and should be protected by an effective withholding notice.

45. A sum which was not otherwise "due" under the contract will not become "due" (and payable) under the contract by reason of any failure to serve an effective payment notice and an effective withholding notice.

46. In the absence of an effective withholding notice, the payer cannot withhold monies against the sum which is "due" under the contract.

Conclusion

47. Despite the decrease in the number of cases dealing with adjudication and payment many questions remain unanswered. Let's hope current reforms will address these. The following is not a comprehensive list, but merely ones which frequently arise:

48. What is required of a payment mechanism in order for it to be "adequate"?

49. What is meant by payment "due"?[35]

50. Is it always the case that failure to serve an effective section 111 notice will lead to enforcement of the Adjudicator's decision regardless of the reasons for non-payment. Currently, it is sensible to serve a Section 111 Notice even where a party is merely relying upon abatement to justify withholding.

51. Is it possible to withhold sums against an Adjudicator's decision?

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[35] A situation made clear in so many contracts when no certificate is issued. This frequently occurs between main contractor and subcontractor. Usually there is no independent third party such as an architect issuing a sacred piece of paper, a certificate. So the debate about what is the sum due becomes an argument in itself. It is tempting to suggest that the subcontractor's application for payment becomes the sum due – that is, the *deemed* sum due – but this would require very plain and clear wording in the contract documents. In those circumstances, an adjudicator may have to decide the *true* sum due, then decide if a withholding notice was necessary.