

## Construction Law

IN THIS ISSUE: 1 Pay when paid clauses unenforceable, except on insolvency. 2 Case study: roofing issues at school's performing arts centre. 3 Managing the risk of insolvency on a construction project. 4 Collateral warranties - more than just ticking a box. Construction & Engineering team news.

### 'Pay-when-paid' clauses unenforceable, except on insolvency

Pay-when-paid clauses, favoured by contractors seeking to pass the risk of not being paid down the chain to their subcontractors, were effectively banned when section 113 of the Construction Act 1996 (the Act) came into force.

The Act provides that pay-when-paid clauses are unenforceable, unless they only apply where the paying party becomes 'insolvent', by one of the insolvency routes defined in the Act. Any other pay-when-paid clause is rendered ineffective by virtue of the Act, whatever the parties may have signed up to. In other words, if the employer became insolvent before the contractor was paid, a pay-when-paid clause could, in theory, be valid and come to the contractor's rescue.

If a non-compliant clause is included in a contract, then not only is it ineffective but all of the payment provisions in the construction contract (and not just the offending pay-when-paid clause) will be replaced by the default provisions contained in the Scheme for Construction Contracts 1998. As well as being futile, non-compliant clauses therefore create great uncertainty and could significantly increase the commercial risk and likelihood of matters ending up in a formal dispute.

The fairly draconian effect of section 113, and the ban on pay-when-paid clauses, mean that disputes have very rarely got as far as the courts. However, the issue was given some detailed consideration by the Court of Appeal in the recent case of *William Hare Ltd -v- Shepherd Construction Ltd* [2010].

The main point in contention was whether the terms of the clause fell foul of the provisions of the Act, because of the way in which the employer's insolvency was defined. Essentially, the problem arose because the wording of the clause was quoted from the original version of the Insolvency Act (IA), whereas the IA was updated by the Enterprise Act 2002 (EA) to refer to various new, additional, statutory insolvency procedures (one of which the employer had used). ↓ Continued on page 2...



#### From the Editor

Welcome to the June 2010 edition of Construction Law, Thomson Snell & Passmore's newsletter highlighting some key issues relating to those involved in the construction industry.

If you would like further advice on any of the issues covered please contact Chris Kirby-Turner.

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➔ Continued from page 1...

The court held that it was not appropriate to imply the updated EA wording into the contract, as it was not the court's business to come to the rescue if a party has made a mistake and mis-drafted a pay-when-paid clause. The Court of Appeal, concurring with the initial judgment of the Technology & Construction Court, held that the

withholding notices that were issued were invalid and that the amount should therefore be paid to the subcontractor.

The case therefore reemphasises that pay-when-pay clauses will only be allowed in the very limited circumstances permitted under the Act, and brings into sharp focus the need to ensure that such clauses are drafted with proper precision. ■

## Case study: roofing issues at school's performing arts centre

Chris Kirby-Turner acted for a main contractor in relation to a complex multi-party dispute arising from issues with the roofing to a large auditorium roof at a London school.

Following multi-party negotiations, it was agreed that the subcontractor would return to site and carry out the repairs to the at its own cost.

Our client was appointed as main contractor to build a performing arts building at the school. The London Borough's design team carried out all of the design work and specification for the works. Our client subcontracted the roofing works out to a specialist roofing subcontractor and employed a consultant Project Manager to oversee the works on their behalf.

The roof suffered from persistent leaks, despite the subcontractor's attempts to make watertight repairs to a number of penetrations through the roof, where there were connections to various items of air conditioning plant on top of the roof.

It had emerged that the specified roofing panels had not been used, but a similar product produced by a different manufacturer (with a slightly different profile) had been used instead. The London Borough's design team alleged that the installed roof should be removed and replaced with the specified roof in its entirety.

Our client was stuck in no-man's land, with a very large liability, as they had no knowledge of this unauthorised substitution and, when the subcontractor was questioned, they claimed that the Project Manager had authorised the substitution. He in turn denied this.

It became apparent that there was a potentially very serious conflict of interest at the London Borough, who had both design responsibility for the scheme and were also given full control of the dispute by the school.

Access was eventually agreed, and we instructed the expert to produce a report. The expert's conclusions detailed that whilst it was possible that the replacement product had increased the likelihood of problems with the roof, the specification and design of the roof were inherently flawed. He also made proposals for the repair, rather than replacement, of the roof and confirmed that the wholesale removal of the roof and replacement with the specified product would by no means guarantee that the roof would work properly (even though it would then meet the letter of the specification).

Following multi-party negotiations, it was agreed that the subcontractor would return to site and carry out the repairs to the roof at its own cost, whilst the London Borough agreed to accept repairs to the existing roof and to issue instructions for paid variations to the design of the plant and its steel supports (as well as finally agreeing the long outstanding final account).



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## Managing the risk of insolvency on a construction project

A recent report by PriceWaterhouseCoopers found that although the effect of the downturn on businesses in the construction industry is easing, it is still the hardest hit with 674 construction companies affected in the first quarter of 2010.

There are inevitably pitfalls to consider, but ultimately offering some assistance may be one of the better ways to reduce the commercial risk.

Nearly all standard building contracts contain provisions that enable the construction contract to be terminated in the event that a party becomes insolvent during the course of a project. The procedure for terminating the contract must be followed very precisely, in order to avoid exposure to claims.

Any adjudication, arbitration or court proceedings currently running when a company becomes subject to the formal statutory insolvency procedures (such as liquidation, administration, a creditors' voluntary agreement, etc) will be immediately subject to a moratorium. The moratorium puts a halt to all current proceedings, precludes new proceedings from being started, and also puts a halt to any enforcement proceedings of an existing decision. It is only in exceptional cases that an application to lift the moratorium will succeed.

Clearly an insolvent contractor (or subcontractor) is one of the worst case scenarios for a developer (or main contractor). In the current economic climate, the best approach remains to take an active, ongoing, interest in your project so that any indications that your contractor is running into financial difficulty can be identified early on.

Some practical steps are set out opposite. However, it goes without saying that none of these steps are risk free. For example, directly paying sub-contractors could lead to a claim of preferential payment under the Insolvency Act, potentially resulting in the payments to sub-contractors being set aside and you having to pay sub-contractors twice.

Also, paying direct may not discharge the obligations to pay the sub-contractor under the building contract.

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### Practical steps

Early warning signs to look out for include:

- staff turnover that is particularly high, or staff numbers being radically reduced
- the contractor falling behind on monthly progress reports
- works slowing down: short labour, late delivery of materials or sub-contractors failing to show because of non-payment
- requests being made for payments to be made on account and
- the contractor's (or subcontractor's) 'extras' claims increasing, as they try to claw back money.

Terminating the contract is not necessarily an attractive option. Instead, the project may ultimately be less adversely affected by other measures, such as:

- shortening contractual payment cycles
- making payments on account
- agreeing to the transfer of the contract to another contractor and
- making direct payments to sub-contractors.

There have been very few cases involving collateral warranties in the English courts. However, the recent Scottish judgment in the combined cases of *Scottish Widows -v- Harmon* and *Scottish Widows -v- Kershaw* will be persuasive down south.

## Collateral warranties - more than just ticking a box

The case involved defects in the roof and curtain-walling to Widows' headquarters and consultants were sued under warranties. The main point found by the Court gave effect to the principle behind warranties - their commercial intention - thus reinforcing the rights of beneficiaries to recover costs of dealing with defects even though not party to the original contract.

The Judge said warranties "must be construed in such a way as to further their essential purpose, namely to ensure that the party who suffers loss has a right of action..." and the fundamental purpose was "...to provide a right of action to a person who is liable to suffer loss as a result of defective performance...". So if you have a warranty, the warrantor has carried out defective work and you suffer loss, you can sue.

The Contract (Rights of Third Parties) Act was heralded as the 'death-knell' of collateral warranties, but as the Act allows everyone to opt out, most have - the JCT rushed out a standard amendment doing precisely that, which has been

almost universally adopted. So to paraphrase Mark Twain on death, reports of....need we go on!

So the message is clear - it is not just a box-ticking exercise and they are worth the paper they're written on. There is no reason to suppose the English courts will not take the same line as Scotland. Beneficiaries - protect yourselves and get a full package of good warranties. Those giving them - you cannot now assume they are worthless and won't be relied upon.



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## Construction & Engineering team news

The next meeting of the TSP+ Property & Construction Club, a regular breakfast event offering an opportunity to network for those involved or interested in the property and construction sectors in the Thames Gateway region, will be taking place on 23 September 2010. If you would be interested in further details or would like to attend, please contact Chris Whittington by email at [chris.whittington@ts-p.co.uk](mailto:chris.whittington@ts-p.co.uk)

The firm recently launched its new website, which includes a new Construction & Engineering section as well as information on the other teams with which we work closely. There is also a large knowledge section containing case studies, articles and publications. We hope you find it interesting and informative, and welcome any feedback.



Although this newsletter highlights some key issues relating to construction law, it should not be considered comprehensive and is not a substitute for seeking professional advice on a specific issue.