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Author : Roger Trett
Title : Introduction - Who Pays the Piper?

Introduction - Who Pays The Piper ?

I have recently been appointed as an Expert Witness for quantum in an Arbitration in which the Claimant is seeking recovery of the costs incurred in preparing his claim - by no means an unusual state of affairs. I have been asked my opinion as to whether the Claimant is entitled to be paid such costs. The preparation and assessment of claims is a significant part of our business, and the extent to which our costs may be recovered by our clients is of considerable interest to both of us.

In my capacity as Expert Witness on quantum I am not, of course, required to decide whether such costs are recoverable or not. That decision is for the Arbitrator. I can only give an Opinion as to the actual amount of the claim - were the claimed costs actually and reasonably incurred. However, I may well be examined on my views on this particular matter in addition to my formal Opinion on quantum.

So do I consider such costs are recoverable? My answer is that it all depends. Contracts generally provide for additional work by variations, and for the submission (and therefore preparation) of claims by the Contractor in proper response to certain events. For example, where the Employer is in breach by not providing due information in time to avoid disrupting the works, then the Contractor has contracted to prepare and submit sufficient information (i.e. a claim) to enable his entitlement to damages to be fairly assessed.

The basic legal entitlement in the event of breach is that the sufferer is to be restored, so far as payment will allow, to the position he would have been in had the breach not occurred. It would follow that his claim preparation costs must therefore be reimbursed as an element of his damages. But when such claims are contemplated in the contract, it may be argued that the Contractor has provided for the necessary resources within his rates and prices. He has an administrative or management structure in place for dealing precisely with such matters. He may employ permanent specialist legal staff to advise in such circumstances. When those resources are brought to bear on a particular claim issue, the Contractor does not suffer additional cost thereby, since he incurs the cost of those resources anyway, so he sustains no damages in that respect. In my view that is an acceptable argument, subject to degree. The Contractor should absorb the claim preparation costs to the extent they may be reasonably considered to have been within the contemplation of the parties.

It follows then, that if the Contractor finds it necessary to solicit outside assistance for the proper preparation of his claim, then such costs would not fall within that category and he should reasonably be entitled to reimbursement.

He would, of course, need to show that he does not have the in-house resources or necessary expertise available - he cannot be allowed to duck out of his contractual obligations without good reason. Similarly, if the deployment of in-house resources is significantly greater than what might reasonably have been contemplated, then he should be entitled to claim the excess.

A rather different situation exists when the claim arises from a breach which is not contemplated in the contract. I suggest in such cases the Contractor is entitled to recover his entire demonstrated costs, subject to the normal legal provision with regard to damages. In that event he would need to ensure that both in-house and external staff allocation were carefully identified, allocated and recorded.

What do you think?

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Author : R Pearce
Title : Set off and Insolvency

SET OFF AND INSOLVENCY - All For One Or One For All?

Set-off against insolvent companies is, in my experience, the largest contributory factor preventing substantial recovery by debenture holders and creditors alike in the construction industry. As a practice it may seem quite proper under normal circumstances but, I suggest, is quite damaging when exercised against an insolvent company.

The distribution of the assets of a bankrupt and setting off of credits and debits has long been the subject of legislation and case law. As far back as Elizabethan times statute required the Commissioners in bankruptcy to pay *"to every of the said creditors a portion, rate and rate alike, according to the quantity of his or her debts"*.

The basic objectives of modern insolvency laws are said to be that:

1. Actions by individual creditors against the insolvent company are frozen. This is generally true in fact and in practice.
2. All assets of the insolvent company belong to the pool which is available to pay creditor claims. This is doubtful and is particularly not true when there is a charge on those assets or when set-off is exercised.
3. Creditors are paid pro rata out of the assets according to their claims. In reality this is not the case because of the statutory application of preferences and set-off.

Insolvency law is now very complex indeed and goes to extreme lengths to ensure the proper distribution of assets, in accordance with preferential rank. Yet in the absence of more measured and tangible security, the act of setting off against the insolvent company persists to the express benefit of certain parties and the dis-benefit of others of equal or higher rank.

In reality, the ranking of creditors could be set out as follows:

1st : "Super Priority" Creditors

Banks, Debenture-Holders and creditors with set-off

2nd : Priority Creditors

Employees, Government

(another sensitive area)

3rd : "Ordinary" Creditors

Trade Creditors (if not able to "promote" themselves by set-off)

4th : Deferred Creditors

Equity and Equitably Subordinated Creditors, Interest

5th : **Equity Shareholders**

Members, Shareholders

6th : **Expropriated Creditors**

Late Claimants, Tort Claimants, Foreign Currency

In the majority of insolvency situations, there are many creditors and, by the nature of the insolvency, simply insufficient funds to satisfy the creditors' claims. There will inevitably be damaging repercussions on a number of these creditors who just so happened, by coincidence of time, to be trading with, and in credit with, the now insolvent party.

A typical situation to consider is where construction company 'C' becomes formally insolvent and, being at the time concurrently in two similar contracts with employers 'A' and 'B', leaves both with substantial claims for the additional cost of completing the Works and/or rectifying defective work.

Employer 'A' may, by a coincidence of events or timing, or just by the fact that it is an honest and fair employer, have paid 'C' on time and in full and will therefore have to make an unsecured creditors claim. Employer 'B' on the other hand, not having paid on time or in full due to a coincidence of events and/or timing, or by design, will, according to most construction contract conditions and the body of current law, simply be able to set-off its claim against the monies due, or becoming due to the now insolvent contractor, simultaneously reducing any monies available to satisfy employer A's claim.

The difference in outcome for the two employers in this example is stark and may apply in almost any trading situation; employer/ contractor, contractor/subcontractor, subcontractor/sub-subcontractor, supplier/contractor and so on.

The apparent injustice of this is clear, and has the further added injustices of:

(a) possibly depriving other creditors of the insolvent company of recovery, be they chargeholder, preferential or just unsecured creditors, possibly bringing about their own insolvency, together with further repercussions down the line to their own creditors, and

(b) increases the tendency towards late payment by debtors which is naturally exacerbated at a time when it may be felt that the company is at risk of becoming formally insolvent and may itself bring about or accelerate formal insolvency.

The potential for knock on effects elsewhere in the industry is clear because the subcontractors and suppliers are as dependant themselves on cash-flow as the main contractors. Difficulties experienced by subcontractors and suppliers will impact on another project, for another main contractor, for another employer... and so the spiral continues - a contributory factor to the boom-and-bust nature of the UK Construction Industry.

When a set-off is exercised by a potential creditor company against the insolvent company, the effect is to 'promote' that creditor above others, to the detriment of those others who may have higher ranking claims or even be secured. This flies in the face of the underlying principle of *pari passu* (i.e. that there should be no preference between creditors). This seems to have come about by the Courts use of equitable set-off in discrete cases, permitting a cross claim against an insolvent company without considering the wider effect in depriving other creditors of their recovery.

SO WHAT IS EQUITABLE SET-OFF?

Set-off is, primarily, the setting of two or more claims against each other in order to produce a single balance.

As a procedure, it provides a defence to an action but is not necessarily dependant upon the instigation of an action in the Courts, i.e. it may mitigate against a balance due in a set of mutual transactions, producing one balance due to one party or the other, which is paid in the normal course of business.

Equitable set-off does not rely on any contractual provision and case law has shown that in the absence of very specific wording in the contract or subcontract, the right to equitable set-off cannot be excluded. What is required for equitable set-off to apply is sufficient connection or nexus between monies due on the one hand and monies claimed to be set-off against these on the other so as to merit such set-off.

Whilst equitable set-off is a relatively wide remedy, it does not usually extend to setting off claims under different contracts unless there is express contractual provision to so do, but then this would be a contractual right of set-off rather than equitable.

It may be allowed against a receiver even though it arises after the date of the notice of assignment and is hence the form of set-off commonly applied against the insolvent, e.g. for defects coming to light after the contractor has become insolvent.

However, even though the claim and cross claim arise from the same transaction, this does not mean that equitable set-off will always apply.

In the case of **Dole Dried Fruit and Nut Company V Trustin Kerwood Limited**, it was held:

"It may even be insufficient that claim and cross-claim arise out of the same transaction, unless they are so inseparably connected that one ought not to be enforced without taking account of the other."

A MATTER OF CONSCIENCE?

In the case of an employer seeking to reduce or entirely avoid payment of an outstanding Certificate for Payment or subsequent release of retention monies by the use of equitable set-off, the test used by the Courts is that the claim and cross-claim must be so closely bound as to make it 'unconscionable' to disregard the cross-claim. The application of this test in practice in allowing set-off for the benefit of one party, e.g. employer 'B' in my example, seems to disregard the dis-benefit to other creditors of equal or higher rank.

In terms of *pari passu*, and the equity upon which such set-off was founded, would it be more 'conscionable' for these two creditors to receive, potentially, a dividend of equal proportion than for one to be satisfied in full and the other, as a consequence, receive nothing?

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Author : Anthony Farrow
Title : The Problems of Being A Sub-Contractor - Part 3

Following Through A Contract From Start to Finish

In this three part article, Tony Farrow looks at some of the difficulties of being a sub-contractor. In parts one and two the tender and pre-site periods were reviewed. In this final part, events after the works have commenced on site are considered.

ON-SITE PERIOD

Turning now to the main period of the sub-contractor's project involvement - the on-site period. Many problems will manifest themselves at this time, but their underlying cause will sometimes be due to events and decisions made earlier. Issues include:-

- Clarifying the status of works prior to commencement
- Progress monitoring
- Labour allocation
- Receiving payment
- Beneficial use of the works

Many sub-contractors will be aware of the popular clause in sub-contracts, that the sub-contractor is to inspect the 'prior works' ie those of the preceding trade, to confirm they are 'suitable' for incorporating the sub-contract works. These clauses are often ambiguous and in my mind, a bit of a cop-out for the main contractor. For example, the employer has an architect or equivalent professional supervising the works and the main contractor is engaged in managing the whole site process, including those works carried out by these 'preceding' sub-contractors. So why should the next-in-line sub-contractor have to carry out a third check as well? It is unlikely that all the prior works will be complete by the time the sub-contractor starts - the process is an on-going one.

I have just completed a case where the prior works were clearly not sufficiently advanced but the sub-contractor was given his contractual 4 weeks notice to start. Having pointed out the unsatisfactory status of the prior works he was told to stop being awkward and mobilise, or be in breach. The sub-contractor started but pulled-off after 3 weeks and re-mobilised 2 months later!

Progress monitoring is a key task, from a construction management point of view, as well as from the 'claims insurance' point of view. In Part 2 of my Article, I talked about the programme and the divergent purposes of it to the employer, main contractor and sub-contractor. Now the project is underway, the sub-contractor must record what he is doing, who is doing it and when. I am often told that the reason there are no progress records on a job is because "we could not agree a programme". However, it is imperative that the sub-contractor's site staff have a system of recording what is being done. The records must indicate the area (building, floor, level), the construction sequence (first fix, second fix, final fix) and the work (gas lines, cold water services, drainage, rebar etc).

The **labour records** must be linked into the progress recording system so that who is doing the work and how long it takes can be ascertained. If I was asked which one category of progress records I would like to have, it is a well detailed labour-allocation system. These always provide enormous benefit when undertaking a retrospective review of a project. The problem, sub-contractors will say, is that they do not have the time to complete the records. My own view is that time is not a problem, it is the lack of discipline and commitment.

Photographs and videos are also an excellent record of what is happening on site, identifying the status of the entire job, not just the sub-contractor's works. I find they are incredibly useful to defend a main contractor's challenge that the sub-contractor was in delay. (That is why many sub-contracts now refuse the taking of photographs on site!).

Having recorded progress, it needs to be reported to the main contractor. This can be done at the weekly/monthly site meetings. Ensure that what is said is recorded properly. If the main contractor is unwilling to record your comments fully, keep a file note of your point ... and do not accept minutes that distort the picture.!

One of the most important aspects, if not the most important aspect, of the sub-contracting business is **getting paid**. If anyone has come up with a fool-proof system please, please let me know! Sub-contractors have been badly treated in the past and this will be the case in future, in my opinion, despite new legislation and revised contractual machinery. If times are hard, payment will slow down. If there is some concern or dispute over the validity of a claim or the quality of workmanship, monies will be withheld. And as long as the industry operates on the basis of 'do the work now and we'll agree the price later', the party doing the work and spending the cash, will always have to wait until someone else up the contractual chain decides what the value is and will then have to wait until someone else then agrees to provide a cheque for it.

A final problem I would identify in the on-site period arises from the **beneficial use** of the sub-contractor's works. This is particularly relevant to M&E services, where the period of warranty may be extended by several months or even a year because, say, the boilers and heating system are used to dry the building well before practical completion. Beneficial use can also greatly affect the efficiency of the commissioning process, often resulting in repeated testing or balancing activities - so increasing the sub-contractor's costs. However, my greatest complaint from the sub-contractor's angle, is that whilst there is goodwill from the sub-contractor when he accepts that his plant is used early, when there is a problem later, either in the commissioning phase or in the maintenance period, there is little reciprocation from the main contractor, consultants or employer.

POST COMPLETION

There are two primary problems for the sub-contractor once the works are complete:-

- agreeing the final account and getting paid
- defects

Most contracts specify a period during which the 'final measure' is meant to take place. The clause is like the *speed limit* - everyone knows what it is, but no-one ever abides by it. I offer a prize for anyone who can recall a project when the final account is agreed and paid within the contractual period!

For most sub-contractors, the pace for setting the final account will be dictated by the main contractor's efforts in getting his account settled with the employer, which will be dependent upon other factors, such as the urgency placed upon it by the employer and his consultants. The main contractor will wish to resolve the big issues most affecting him first and so some sub-contractors' accounts will be put well down the list of priorities. This situation results in the sub-contractor having to wait for his money (again), but it emphasises why sub-contractors need to be 'pushy' when it comes to getting their accounts settled. A sub-contract QS friend has a pin board in his room on which he records the excuses he receives as to why he cannot be paid or the account agreed he will soon need to move to a bigger room to accommodate a larger pin-board!

One of the reasons why the account settlement is held up is because of workmanship, material or plant problems. I have had projects where there were major problems with the floor screeds or floor finishes, for example, and the contractor, employer and the consultants

are into lengthy discussions, debate and investigations. This has resulted in months of delay in further payment to me, involving substantial finance costs, on a job where we had installed the M&E services! The problem is, when there are major workmanship problems on a project, everyone's accounts and cash flow suffer.

CONCLUSIONS

In the three parts of my article, I have logged some of the problems of being a sub-contractor. I know I have not offered solutions in most cases, but at least knowing the problems allows one to price the risk. But this is easier said than done, when there are so many companies willing to compete for the work and so little work to go round. The fact of the matter is that sub-contracting is a high risk/low margin business and this is probably the key reason why the construction industry has the largest number of insolvencies and receiverships of any business sector. My recommendation to sub-contractors is become a Buddhist and in your next reincarnation come back as a main contractor or better still, a banker!

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Author : M Hopkins
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DESIGN OBLIGATIONS OF DESIGN & BUILD CONTRACTORS
How to determine how onerous they are and what are the practical implications
INTRODUCTION

This article considers the contractual design liabilities of contractors who undertake work that involves some element of design and the practical implications of those obligations.

DESIGN OBLIGATIONS GENERALLY RECOGNISED BY LAW

There are generally only two standards of design obligation which are likely to arise. Firstly, a Contractor may be subject to a duty to use reasonable skill and care, alternatively, they may be under a duty to ensure that the completed works are fit for their intended purpose.

REASONABLE SKILL & CARE

This is the bottom line design obligation for all design consultants. The duty may be provided for by way of an express contractual term or in the absence of an express term there would almost certainly be an implied term to the same effect.

The courts have considered the requisite standards required for 'skill and care' in numerous cases. Perhaps the best definition for skill and care came from the Court of Appeal in **Eckersley -V- Binnie & Partners 1988**. In that case Bingham LJ stated

"the law requires of a professional man that he live up in practice to the standards of the ordinary skilled man exercising and professing to have his special professional skills. He need not possess the highest expert skill; it is enough if he exercises the ordinary skill of an ordinary competent man exercising his particular art. In deciding whether a professional man has fallen short of the standards observed by ordinary skilled competent members of his profession, it is the standard prevailing at the time of the acts or omissions which prove the relevant yardstick. He is not to be judged by the wisdom of hindsight."

This means that a Contractor will be judged by comparison to the standards of the average competent Contractor operating in the same sort of business with the knowledge and expertise that the average Contractor would have had at the time of the alleged failure to act with reasonable skill and care.

In the absence of contrary contractual provisions, professional designers such as architects and engineers will generally only be subject to a duty to exercise reasonable skill and care in the preparation of their design. However, the courts are less inclined to limit the design liability of a design and build Contractor carrying out the same functions to reasonable skill and care.

FITNESS FOR PURPOSE OBLIGATION

For a fitness for purpose obligation to be satisfied the completed project must be fit for all purposes for which it could reasonably be anticipated that it would be used. The obligation is absolute. The Contractor cannot raise by way of Defence that he exercised all reasonable skill and care.

It is generally accepted that design and build Contractors will, in the absence of contrary express provisions, be subject to fitness for purpose obligations. The rationale would appear

to be that as a design and build Contractor is delivering a completed project they are in a position akin to a manufacturer of a product. Most of us would accept that a car manufacturer should be under a duty to supply a vehicle which is fit for its purpose.

WHEN WILL THE DIFFERENT STANDARDS APPLY

The following two cases constitute practical examples as to how the courts have approached matters.

IBA -V- EMI Electronics Ltd & BICC Construction Ltd 1980

EMI were main contractors employed by IBA for the construction of the Emley Moor Television mast in Yorkshire. BICC were specialist sub-contractors nominated by IBA for the design, supply and erection of the mast. The completed mast broke and collapsed following harsh weather conditions. The House of Lords held that BICC had been negligent in the design of the mast, and that EMI were under a contractual liability to IBA for the design of the mast encompassing responsibility for the negligence of BICC.

In his Judgment, Lord Scarman stated:

"... in the absence of a clear, contractual indication to the contrary, I see no reason why one who in the course of his business contracts to design, supply and erect a television aerial mast is not under an obligation to ensure that it is reasonably fit for the purpose for which he knows it is intended to be used the critical question of fact is whether he for whom the mast was designed relied upon the skill of the supplier (i.e. his or his sub-contractor's skill) to design and supply a mast fit for the known purpose for which it was required".

Greaves (Contractors) Ltd -V-Baynham Meikie & Partners [1975] 2 Lloyd's Rep. 325

This case related to a design and build contract where contractors had agreed to design and construct a warehouse. The contractor engaged structural engineers (as a sub-contractor) to design the structure of the warehouse and both the contractor and the engineers were aware that the first and upper floors of the warehouse would have to take the weight of fork lift trucks carrying heavy barrels of oil. These floors began to crack as a direct result of the vibration from the fork lift trucks. The Court of Appeal held that there was a term to be implied in the engineers' contract that they should design a warehouse fit for the purpose for which it was required. Lord Denning made the following often quoted statement :-

"The law does not usually imply a warranty that he will achieve the desired result but only the term that he will use reasonable skill and care. The surgeon does not warrant that he will cure the patient. Nor the Solicitor warrant that he will win the case. But, when a dentist agrees to make a set of false teeth for a patient, there is an implied warranty that they fit his gums, see Samuels -v- Davies 1934".

Considering the above two cases we can see that even in the absence of an express contractual term the courts are inclined to imply fitness for purpose obligations into design and build contracts and especially so where the design and build Contractors are apparent specialists in a particular field.

One of the most widely used forms of building contract in respect of design and build projects is the JCT 1981 Form of Building Contract. Under ICT 1981, the design and build contractor's design liability is restricted to the lesser obligation of using reasonable skill and care. This is achieved by the warranty set out at Clause 2.5.1 of the Contract which provides:

"2.5.1 ...the Contractor shall have in respect of any defect or deficiency against such design the like liability... as would an architect... who, acting independently under a separate contract with the Employer, has supplied such design for or in connection with the works to be carried out and completed by a building contractor not being the supplier of the design."

The warranty contained in JCT 1981 operates by referring to the common law position of a professional designer not himself carrying out the design work as part of a design and build package. If the last three lines starting with the "Who" were to be deleted, there is every prospect that the Court would hold that the Contractor's obligation is one of fitness for purpose since that vital part of the common law yardstick has been omitted.

PRACTICAL IMPLICATIONS

In terms of defending any claim brought by the Employer the Contractor will be in a much better position if it is under a skill and care duty. To establish breach the Employer will firstly have to prove on a balance of probabilities that a defect exists and that the Contractor was at fault. This second requirement involves proving as a matter of law that the Contractor failed to exercise reasonable skill and care. This will involve showing that it failed to apply good practice and failed to do what the ordinary competent Contractor would have done. This is likely to need extensive investigation, expert evidence and a high level of legal representation.

By contrast, where there is a fitness for purpose obligation the employer will only have to prove on a balance of probabilities, as a matter of fact, that a particular fitness for purpose requirement has not been met.

CONCLUSION

Consideration of the common law principles which concern the level of a Contractor's contractual design obligation illustrates the fact that, even where there is no express obligation, the level of the Contractor's design obligation will be that of ensuring that the works are fit for purpose, there is every prospect that without express limitation (such as the warranty to be found at Clause 2.5.1 of JCT 1981) that the more onerous obligation will apply.

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