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Construct.Law

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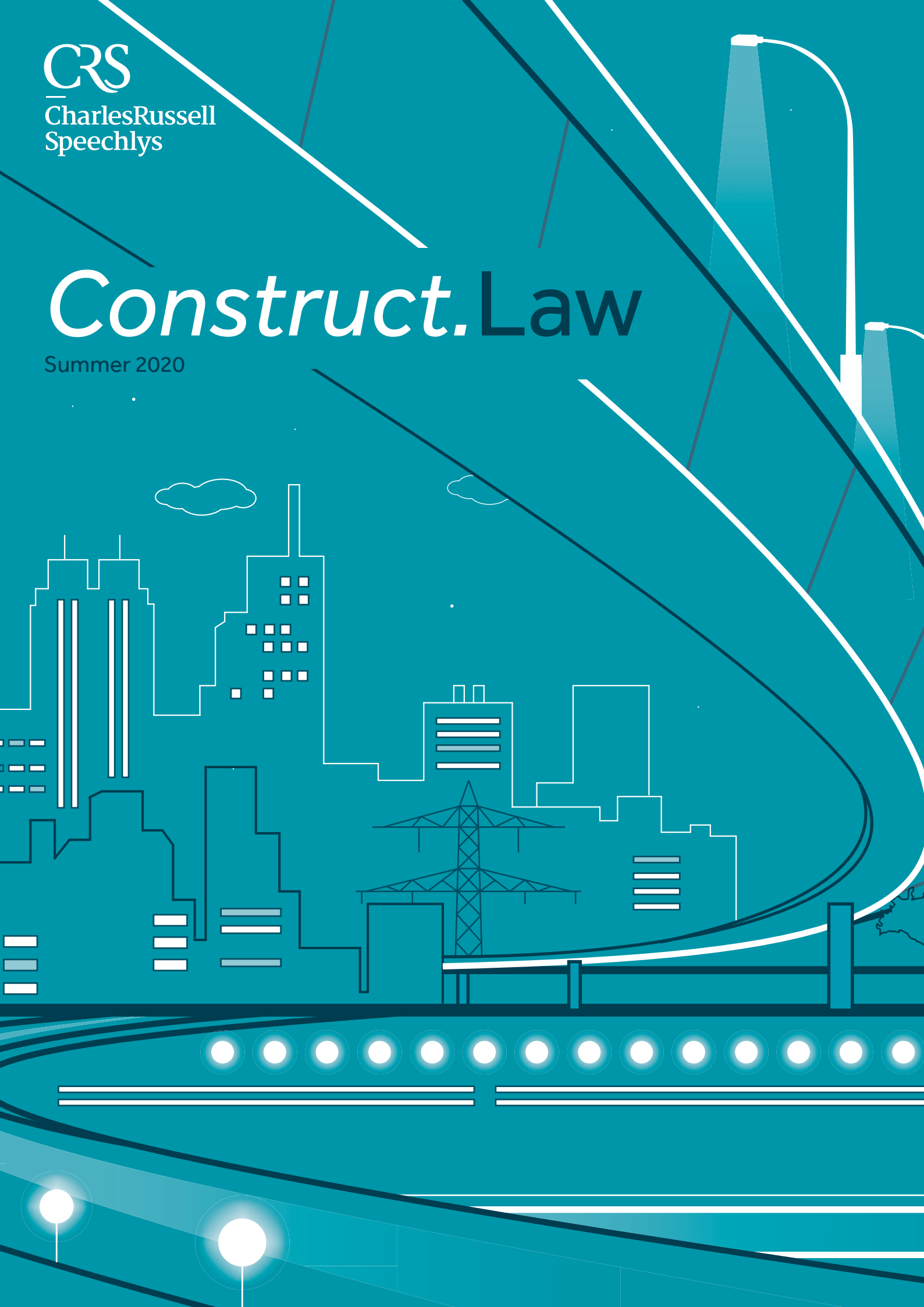

Contents

Introduction

Welcome to the latest edition of our construction, engineering and projects publication, Construct.Law. Inevitably the impact of COVID-19 continues to dominate the headlines and affect our daily lives, both personally and professionally. This edition considers the impact of the crisis on both global supply chains and local site-level health and safety issues.

Aside from COVID-19, the Supreme Court's decision in *Bresco Electrical Services Ltd (In Liquidation) v Michael J Lonsdale (Electrical) Ltd* has generated much interest from the industry. With insolvencies sadly expected to increase in the coming months, it is perhaps timely that liquidators have now been permitted to commence adjudications (although challenges remain at the enforcement stage).

This edition also includes interesting and wide-ranging articles on issues such the HMRC's crackdown on personal service companies, the use of drones to collect data and the exclusion of indirect and consequential losses. There is an update on the Government's reforms to the building safety regime in response to the Grenfell tragedy. Finally, we get back to basics and look at the law relating to variations.

We hope you enjoy reading this edition of Construct.Law. If you are still keen for more legal content, you may also be interested in our regular podcasts, which include a recent discussion between Steven Carey and myself on the Bresco case. Please do get in touch if you would like to discuss any of the issues covered by Construct.Law or if there are any topics which you would like us to cover in future editions.

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Government publishes Building Safety Bill

In a landmark bill that will be of interest to all those involved in the development, design, construction, ownership and management of buildings, as well as their residents, the Government has set out its draft legislation for a radical overhaul of building safety under the Building Safety Bill.

Ben Wilkins
Associate
Construction

Taken together with the *Fire Safety Bill*, currently passing through parliament, and the establishment of significant funds aimed at replacing both ACM and non-ACM cladding, these measures comprise the most wide-ranging reforms in building safety for 40 years.

Building Safety Regulator

Initially confirmed by the Government in January 2020, Part 2 of the Bill sets out the functions of a new Building Safety Regulator (**BSR**), operating within the Health and Safety Executive.

The BSR will be responsible for overseeing the safety and standard of all buildings and will also have a duty to improve the competence of all persons involved in the built environment industry. Notably it will directly oversee the competence and performance of building inspectors, who will be required to register with the Regulator.

A person found to have provided false or misleading information to the BSR may be guilty of a criminal offence and liable for a fine or up to two years in prison on indictment.

A new stricter regime for 'higher-risk buildings'

Moreover, under the Bill the BSR will be directly responsible for implementing and enforcing a new stricter regime for 'higher-risk buildings' and for making key regulatory decisions at points during the design, construction, occupation and refurbishment of buildings.

Responsibility for determining the parameters of which buildings will be deemed a 'higher-risk building' will fall to the Secretary of State, who must consult the BSR, though it is currently understood it will apply to all buildings of 18 metres or more in height, or more than six storeys.

The Bill also sets out that the 'accountable person', deemed to have responsibility for various tasks relating to building safety and engagement with residents, would be the person who holds a legal estate in possession of any part of the common parts of a building or who is under a relevant repairing obligation in relation to any part of the common parts. The Bill also includes various provisions relating to Dame Hackitt's proposals for a 'golden thread' of digitally stored data relating to Building Safety, which must be updated and made accessible to the BSR and to residents throughout the lifecycle of the building.

Bill likely to face considerable scrutiny

In publishing the Bill the Government has said that it is keen for it to receive further views from parliamentarians, residents and industry via the Parliamentary process of pre-legislative scrutiny, before the Bill is then introduced to Parliament.

It is also notable that the Bill has been published by the Government in conjunction with a consultation paper setting out proposals to implement recommendations from phase one of the Grenfell Tower Inquiry.

We will keep a close eye on developments as the Bill progresses through Parliament.

Global supply chains in the COVID-19 era: 10 things we have learned so far...

With construction and infrastructure sites increasingly operative around the world, and most governments keen to lift lockdown restrictions more broadly across their economies, it seems like an opportune time to ask ourselves what we have learnt about supply chains during the unprecedented times (in peacetime at least) we have been journeying through, and what that might mean for construction and infrastructure supply chains going forward. It is not just the UK Government that has had to learn tough lessons on procurement and risk distribution in global supply chains.

David Savage
Partner
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International construction and infrastructure supply chains are complex. Some have proven resilient, while others have not. Construction lawyers understandably tend to focus on construction contracts, but construction and infrastructure supply chains descend far below the main and subcontract levels with which we are familiar. The problems and challenges encountered further down supply chains are the genesis of much of the time and cost pressures resulting in claims under those contracts on which we advise. The COVID-19 crisis has, of course, been the ultimate storm, impacting labour, logistics, distribution, and merchants both simultaneously and globally.

As we are now moving from what I call the "COVID-19 crisis" to the "COVID-19 era", here are ten things I believe the COVID-19 crisis has taught us that we need to understand as we move into the COVID-19 era and consider re-engineering construction and infrastructure supply chains:

1. **Supply chain structures are, and supply chain management is, complex:**
   Both need to change: global v local, single source v multisource, China v other production jurisdictions, framework/collaboration agreements v tight one off supply terms and conditions. Each of these risk "dials" in supply chain management will need to be evaluated and recalibrated in the light of recent experience. The exact right mix will look different for each business, but some likely trends are clearly identifiable already.

2. **Looking after your own people makes business sense and enables change:**
   It is trite to observe that all business is ultimately people business. Your own staff will be making constant judgments about their own organisation's performance and values. Your ability to manage and adapt your supply chains starts with an engaged and motivated staff who are up for those challenges. By demonstrating that their welfare is central in your organisation's planning, you will better equip your organisation to respond and adapt to the challenges of the COVID-19 era. Right now, that includes coaching them back into work if they have been furloughed for months, and helping them feel confident about their workplace, whether that is head or regional office, or a construction site. There is self-evidently a role for sector leadership here. In the UK, the Construction Leadership Council (CLC) and BuildUK should be commended for the work they have done in producing both the initial Site Operating Procedures (published right at the beginning of lockdown) and the four subsequent and more detailed versions since.

3. **"Global v Local" is a debate that may not be as binary as it looks:**
   Professor Tim Benton of Chatham House commented recently *"... we have created global supply chains that, for all their efficiencies, have very little resilience."* The temptation is to see global v local sourcing as a simple binary choice to mitigate risk and build resilience in supply chains. The reality is more complex, as your decision to relocate to a more local supplier only makes sense if their supply chain is equally re-profiled. That involves supply chain mapping someone else's supply chain. A different way to think about supply chain risk might be the relative complexity of that chain, with a focus on "complex to simple" where that is possible to achieve. The issue is of course the sheer complexity of existing supply chains generally, even for what are viewed as commodity products. The Economist magazine recently reported on coffee, noting that 29 companies in 18 different jurisdictions typically needed to collaborate to make *"one humble cup"*.

4. **We need to embrace a VUCA world:**
   Volatility, Uncertainty, Complexity and Ambiguity are the new norms. Think climate change, financial markets volatility, global recession, cyber threats, changing geopolitics. Clearly, so far as the COVID-19 era is concerned, we are now needing to move from "emergency response" to recovery, resilience and viability over the longer term. However, that needs to include better preparedness for other global shocks or change. By planning with VUCA in mind, you give your business a head start next time. That may come at a price, but right now evidence of resilience in your supply chains is probably something many clients will be prepared to factor into their purchasing or partnering decision.

5. **Decisions on China remain central:**
   The 21st century was always going to be about China. No one doubts the economic and productive might of China, nor the success of its centrally determined economic policies. Further, as the Huawei debate has illustrated well, China has developed its own R&D capabilities to an extraordinary degree over the last 20 years, such that it is now producing world leading technical components at prices that Western companies simply do not compete currently. Nevertheless, single sourcing critical component or materials supply to one country (or, in some cases, one supplier in one country), has, so far, not always looked like a brilliant strategy during the COVID-19 era. When that country is a communist state, increasingly flexing its muscles on the world stage, then you need to factor the rules and norms of its regime into your procurement strategy. For some sectors (including tech), these judgments and decisions will take years to implement – for example, it is estimated that 290 of Apple's 800 suppliers are currently based in China.

6. **Well run industries demonstrate both innovation and resilience through agile responses:**
   There have been many impressive examples of this during the COVID-19 era so far. My favourite was Woking based McLaren Automotive and Mercedes Formula 1 teams' involvement in the Ventilator Challenge UK consortium, and their development, and rapid manufacture, of an entirely new continuous positive airway pressure (CPAP) device. Deployed at scale, including in the new NHS Nightingale hospitals, the device has not only saved lives, but also contributed to more speedy recoveries by avoiding the need for some COVID-19 patients to be intubated on conventional ventilators. Others included contrasting businesses, brewer Brewdog and luxury goods house LMVH, who both repurposed their supply chains to manufacture hand sanitiser products. One of the reasons Sarah Gilbert's vaccine team at Oxford University's Jenner Institute has done so well so far is that they quickly adapted an existing but different coronavirus (not COVID-19) vaccine programme into the programme, focusing on a COVID-19 vaccine almost as soon as the genetic sequence for COVID-19 was released in early January.

7. **Reviewing your supply chain management is all about the detail:**
   It may start with "judgement" calls on your current position, and a tactical sense of where you need to end up. The shock of the last few months has probably highlighted much of that for everyone. But beyond that tactical planning, much of the work that follows is the hard graft of mapping supply chains, reviewing supplier agreements, refreshing business continuity plans, better embedding resilience, and investing in digitising your supply chain management and processes. It is amazing how few businesses have genuinely undertaken that process, or have embedded plans to routinely do so. Good commercial lawyers can add value to more than just the contract terms review piece here. They tend to be forensically orientated towards risk identification more broadly, and should be able to add value to their clients' endeavours in this area, at least as part of the overall "challenge" discussion around risk identification, allocation, and mitigation going forwards in the COVID-19 era.

8. **For smaller suppliers, your e-commerce platform is key:**
   Many SME participants in construction and infrastructure supply chains, including the merchanting sector, were behind the curve in the immediate crisis when it came to their online offering. For those with a relatively stronger offering, capturing new client data for marketing purposes, and demonstrating more efficient inventory management, is likely to help them hold on to their new clients and broaden their offering going forward.

9. **There are many previously "hidden" interdependencies out there:**
   Remember the fuel crisis during 2000 when Tony Blair was PM? One of the reasons his administration struggled at first in that crisis was that the government had failed – initially at least – to understand the complexity of how fuel is actually distributed within the UK, who owned what infrastructure, and who was employed by whom in those supply and distribution arrangements. The COVID-19 crisis has shone a torch on many similar previously hidden interdependencies. Which of us knew that 40% of international air freight was actually carried on passenger planes? Or that a failure of supply of Chinese consumer goods to Canada would cause a crisis for Canadian lentil and pea producers? (Because a third of Canadian crops are exported in the same shipping containers used for importing electronic and white goods).

10. **"Just in Time" just may not be good enough going forwards:**
    Lean production "just in time" procurement models have been around since the 1960s, and were given additional prominence and popularity by Robert Hall in his 1987 book "Zero Inventories", which advocated resolving inventory problems by seeking to achieve stockless production. Although the economic benefits of such models – while working – are undisputable, this is a classic "dial recalibration" point. It is difficult to see many businesses not choosing to re-calibrate towards at least a greater "buffer" to provide stock cover for critical components. In UK construction, we have seen major disruption to such staples as plaster and plasterboard. The latest results in BuildUK's materials survey suggests that both are likely to remain in short supply for the short and medium term, with aggregates and bricks also reported as harder to obtain than usual alongside plasterboard fixings, insulation materials, and partitioning metal.

This article was first published as a blog by Practical Law Construction on 24 June 2020.

Adjudication v Insolvency Set-Off

It is an unfortunate reality that the number of insolvencies in the construction sector seems certain to rise in coming months as the economic impact of COVID-19 takes effect. In this context, the recent Supreme Court decision in *Bresco Electrical Services Ltd (In Liquidation) v Michael J Lonsdale (Electrical) Ltd* [2020] UKSC 25 is particularly relevant.

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This case concerned important questions regarding the compatibility of two statutory regimes:

- the adjudication of construction disputes pursuant to section 108 of the *Housing Grants, Construction and Regeneration Act 1996*, (**Construction Act**); and
- the operation insolvency set-off pursuant to Rule 14.24 and 14.25 of the *Insolvency (England & Wales) Rules 2016* (**Insolvency Rules**).

While adjudication was intended to resolve disputes on an interim basis for cashflow purposes on a "pay now, argue later" basis, it has quickly become the default method of dispute resolution in the construction industry.

The Insolvency Rules provide that an account be taken of all claims and cross-claims between an insolvent company and each creditor, which has the effect of producing a "net balance" due to the either the insolvent company or the creditor.

The Court of Appeal described adjudication as *"a method of obtaining cashflow quickly"*, whereas the regime under the Insolvency Rules is *"an abstract accounting exercise, principally designed to assist the liquidators in recovering assets in order to pay a dividend to creditors"*. On a literal reading of the individual regimes, both are valid descriptions and stark in their application. In this case the Supreme Court was required to untangle them.

Background

The facts were not in themselves unusual. In 2014, Bresco Electrical Services Ltd (**Bresco**) was employed to perform electrical installation works by Michael J Lonsdale (Electrical) Ltd (**Lonsdale**). Having ceased to attend the site in December 2014, Bresco entered creditor's voluntary liquidation in March 2015. Bresco and Lonsdale made various claims against each other for damages.

In June 2018, Bresco served Lonsdale with notice of intention to refer a dispute to adjudication. Faced with the unappealing prospect of defending an adjudication brought by an insolvent company, Lonsdale sought an injunction from the Technology and Construction Court (**TCC**).

Lonsdale argued that:

- Bresco's claim and Lonsdale's cross-claim had cancelled each other out by the process of insolvency set-off. This meant there was no longer any claim, or therefore any dispute under the contract, so adjudication was unavailable (**jurisdiction point**).
- The adjudication was pointless as the adjudicator's decision would not be enforced until the liquidator calculated the net balance (**futility point**).

Bresco appealed to the Court of Appeal, which upheld the injunction on the basis for the futility point, but rejected the jurisdiction point. Bresco appealed again to the Supreme Court. Lonsdale cross-appealed on the jurisdiction point.

The decision

1. The jurisdiction point

The Supreme Court found that the adjudicator **did** have jurisdiction: the right to refer a dispute under the Construction Act was not extinguished by operation of the Insolvency Rules.

The Supreme Court rejected Lonsdale's argument that claims subject to insolvency set-off lose their separate identity when amalgamated into the final net balance. When a liquidator pursues a claim, it *"remains one based upon the underlying contract, even if an undisputed set-off is acknowledged, or a disputed set-off is raised by way of defence"*. It similarly made no difference as to whether the cross-claim was less (or significantly less) than the claim of the insolvent company, or whether it exceeded it. The only limitation on the adjudicator's jurisdiction was that, in the event the cross-claim was greater, the balance could not be awarded to the creditor by the adjudicator, although a declaration could be made as to its value.

2. The futility point

The Court of Appeal had decided that adjudications brought by insolvent companies would be a waste of time and money for all parties, as the awards could not be enforced other than in "exceptional circumstances" (see *Meadowside Building Developments Ltd v 12-18 Hill Street Management Company Ltd* [2019] EWHC 2651 (TCC)).

The Supreme Court rejected this view: it would be inappropriate for the court to enforce injunctive relief over a party's attempt to *"enforce a contractual right, still less a statutory right"*.

In any event, adjudication, as a mainstream form of alternative dispute resolution, is a tool that can (and should) be utilised in its own right *"...even where summary enforcement may be inappropriate or for some reason unavailable"*. The Supreme Court therefore considered that there may be a practical utility in allowing insolvent companies to adjudicate, despite the potential enforceability enforcement challenges, which could be dealt with on a case by case basis.

As doubtless many companies face the squeeze of the upcoming recession, the ability to adjudicate could potentially become a key tool for insolvency practitioners seeking to efficiently determine claims and cross-claims. Their next challenge will be to overcome the requirement to provide adequate security to the solvent defendant – it is likely that the courts will be asked to consider some creative solutions to this funding challenge in the coming months.

COVID-19 – An overview of the relevant health and safety laws for construction sites

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The Health and Safety at Work Act 1974

The *Health and Safety at Work Act 1974* sets out the overarching legal framework for health and safety legislation in the UK. It lays down the basic duties on all businesses in the UK to protect the health, safety and welfare at work of employees and those not in their employment so far as is "reasonably practicable".

What is "reasonably practicable" requires an assessment of the activity taking place, the risk of harm arising from that activity, the seriousness of the harm that may arise and the measures that could be taken to reduce, or eliminate, that risk. What is "reasonably practicable" will therefore depend on the specific circumstances of any given activity.

The Act also places a duty on employees to take "reasonable care" for their own and others' health and safety, and to co-operate with others. It is of note that the employee's duty has a lower threshold than the employer – to take "reasonable care", as opposed to doing all that is "reasonably practicable". It is also of note that this provision is rarely enforced. However, it can be used to remind employees that they have to take responsibility for their own safety and for that of others, including by complying with safety procedures put in place.

The *Health and Safety at Work Act 1974* is underpinned by a whole raft of regulations which set out additional obligations on employers either generally or by reference to specific industries or specific risks.

Management of Health and Safety at Work Regulations 1999

For the purposes of returning to work under COVID-19, an important obligation on employers is set out in the *Management of Health and Safety at Work Regulations 1999*, which require all employers to prepare a "suitable and sufficient" risk assessment. The risk assessment must be written down where the employer employs five or more people.

Government guidance

On 11 May 2020, the Government issued guidance for "Working safely during COVID-19 in construction and other outdoor work".

This 31-page document is designed to help employers, employees and the self-employed understand how construction work can be undertaken as safely as possible to minimise the risk of disease transmission. It covers 8 broad headings:

- Thinking about risk
- Who should go to work
- Social distancing at work
- Managing your customers, visitors and contractors
- Cleaning the workplace
- Personal Protective Equipment (or PPE) and face coverings
- Managing your workforce
- Inbound and outbound goods

This Guidance makes it clear that it is the responsibility of each employer, having regard to the Guidance, to assess the risks which arise in the specific place of work and to consider how the Guidance can be implemented in a way that makes the place of work as COVID-19 secure as is reasonably practicable.

The Site Operating Procedures

The Government's Guidance has been backed up by Site Operating Procedures published by the Construction Leadership Council. Version 5 of these Site Operating Procedures was published on 4 July 2020. In summary, they provide that:

- Workers should travel to site alone wherever possible. If journeys are being shared, keep to team-sharing, increase ventilation and ensure regular cleaning.
- If private transport is not available, consider staggering start and end times to avoid public transport during the rush hour.
- Hand cleaning facilities (ideally soap and water) should be provided at entrances and exits, as well as throughout the site so that workers can wash their hands regularly.
- Consider site access and egress points, which are a high risk area where it can be difficult to maintain social distancing. Efforts should be made to:
  - Reduce visitors
  - Stagger start/end times to reduce crowding
  - Use signage
  - Implement one-way systems
  - Implement regular cleaning, particularly in areas where workers gather or which have high levels of footfall, common areas and touchpoints.
  - Control toilet facilities to reduce the number of people using them at any one time and to maintain social distancing.
- Careful thought should be given to canteens and rest areas, for example by:
  - Encouraging workers to bring their own food
  - Where there are no practical alternatives, canteens can remain open but should only provide pre-prepared wrapped foods
  - Consider increasing the number or capacity of facilities
  - Stagger break times
  - Crockery, eating utensils and cups should not be used unless they are either disposal or are washed and dried between use
  - Use contactless payments where possible
  - Monitor compliance.
- Similar guidance is given in respect of changing facilities, showers, etc.

These procedures make it clear that sites should not use PPE for coronavirus where the above measures cannot be met.

Records

It is important that appropriate records are kept to demonstrate compliance with statutory obligations in case regulators ask for evidence in the future. This may include risk assessments; photographs of, for example, signage, work stations, barriers, rest areas and others measures to enforce social distancing; training records; and toolbox talks. Ideally records should be kept electronically for safe storage and easy retrieval.

Enforcement

The Health and Safety Executive (**HSE**) is the main enforcing body for health and safety obligations at workplaces, including construction sites.

In the wake of COVID-19, the HSE had paused all but essential enforcement. However, as people are returning to work, the HSE is adjusting its focus and has said it will now be carrying out more site visits.

To support this, the Government has provided a £14m injection of cash to pay for extra call centre employees, inspectors and equipment. In a statement on its website, the HSE says that it is going to resume targeted proactive inspection of high risk industries, and carry out work to check that appropriate measures are in place to protect workers from COVID-19.

In addition to the Government guidance referred to above, the HSE has also produced its own guidance as to how to comply with legal obligations in the context of COVID-19.

In terms of enforcing compliance with health and safety obligations, the HSE has several methods at its disposal. In minor cases of infringement, an inspector may give advice or guidance where it considers it to be appropriate.

However, where the HSE considers that health and safety duties are not being met in a manner which is more serious, it will consider taking formal enforcement steps. There are a number of forms this might take:

- An Improvement Notice could be issued. This is used where there are health and safety breaches which an inspector considers will continue or be repeated.
- An inspector could also issue a Prohibition Notice. This is used where an inspector is of the opinion that an activity which is being carried on involves a risk of serious personal injury.
- As breaches of the health and safety obligations referred to above are criminal offences, a decision could be made to prosecute.

The breach is likely to relate to a failure to do all that is reasonably practicable to protect the health and safety of employees and others affected by the operation of the business. Therefore, in order for a criminal offence to have been committed, the HSE will not need to prove that harm occurred to someone as a result of the failure. In the context of COVID-19. This means that the prosecution will not need to prove that someone actually caught the virus. The relevant issue is likely to be whether all reasonable steps have been taken to protect against the risk.

Often the defendant in this type of prosecution is a company, but the HSE has the power to prosecute individuals. If found guilty and convicted, the sentence imposed by the Court is usually a fine – although the Courts do have the ability to sentence individuals to imprisonment.

The Court must apply a matrix when calculating the fine. Various factors are taken into consideration, including mitigating and aggravating features. However, a key factor in the level of fine for a company will be its turnover (not profit). So even though no one may have been harmed, or contracted COVID-19, as a result of a failure to comply with the requirements, the fine could be substantial – potentially hundreds of thousands of pounds, and if the company is large enough millions.

If convicted, the defendant is usually also ordered to pay the prosecution's legal fees.

In addition to any fine or prosecution costs someone is ordered to pay by the Courts, if the HSE visits a workplace and finds a material breach of health and safety law, it will charge for the time taken to identify the problem and rectify it. This is known as the fee for intervention. The current charge is £157 per hour. Fees can be considerable because the HSE can take many hours to investigate and follow up.

In addition to possible criminal enforcement action, there are other things to consider which may arise because of a breach:

- Firstly, there is the negative publicity which may result if someone becomes ill through contracting the virus, and the significant damage this could cause to the business.
- Secondly, if there has been a death from COVID-19 which may be linked to unsafe working practices on a construction site, there is likely to be an inquest.
- Thirdly, although there are likely to be issues surrounding whether the virus was contracted as a result of unsafe working practices, because it may be difficult to establish where the virus was contracted (the test which the Courts will apply is the balance of probability), there is also the possibility of a civil claim for compensation made by the person who contracted the virus, or by their family if they die.

Challenging an adjudicator's decision – Reserve your right to do so carefully

The recent case of *Platform Interior Solutions Ltd v ISG Construction Ltd* [2020] EWHC 945 (TCC) concerned an adjudicator's decision which was challenged by the subcontractor when the contractor sought payment. This is not uncommon and parties to adjudication proceedings often reserve their right to challenge the enforceability of the adjudicator's decision. In this case, the court considered when a party can effectively reserve the right to challenge an award and whether payment of the adjudicator's fees waives that right.

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Background and adjudication

In January 2018, ISG Construction Ltd (**ISG**) engaged a joinery subcontractor, Platform Interior Solutions Ltd (**Platform**), to carry out works on ISG's redevelopment of a hotel in Edinburgh. In October 2019, Platform commenced an adjudication, claiming that ISG had wrongfully terminated the subcontract and that it was owed over £620,000 plus VAT in respect of interim payment applications and outstanding retention.

The adjudication proceeded promptly and in December 2019, the adjudicator found that Platform's purported termination of the subcontract was unlawful and that ISG was accordingly entitled to terminate the subcontract. She then decided what sum was due from ISG to Platform under the subcontract, being the difference between the value of works that Platform had performed at the date of termination and the cost to ISG to complete the work. The adjudicator calculated that ISG owed Platform over £410,000 plus VAT.

Challenge and payment of adjudicator's fees

When Platform made a demand for payment, ISG refused to pay, challenging the enforceability of the adjudicator's decision. ISG argued that the adjudicator's decision was "invalid and unenforceable" in relation to the valuation of Platform's works and that payment should not be made to Platform.

Importantly, ISG made payment of the adjudicator's fees, whilst reserving its right to challenge the validity and enforceability of the adjudicator's award. ISG's email to the adjudicator of 23 December 2019 stated:

"For the avoidance of doubt payment of your invoice does not constitute agreement that your decision is correct nor does it constitute agreement or acceptance that your decision is valid or enforceable. Accordingly we fully reserve all rights available to us to challenge the validity and enforceability of your decision and all rights available to us to resist any attempt to enforce the same."

In January 2020, Platform issued proceedings in the Technology and Construction Court to enforce the adjudicator's decision. In February 2020, ISG issued separate declaratory relief proceedings challenging the adjudicator's decision which were heard separately.

Waiver of right to challenge

At the enforcement hearing, Platform argued, as a threshold issue, that by paying the adjudicator's fees ISG waived any right to challenge the validity of the adjudicator's decision. Platform argued that the reservation of position made in ISG's email of 23 December 2019 was an ineffective general reservation.

Platform referred to the Court of Appeal decision in *Bresco Electrical Services Ltd v Michael J Lonsdale (Electrical) Ltd* [2019] EWCA Civ 27 182 ConLR 1 where Coulson J discussed the ineffectiveness of general reservations. He stated that the purpose of adjudication under the *Housing Grants, Construction and Regeneration Act 1996*, a fast and effective means of dispute resolution under construction contracts, would be *"substantially defeated"* if a party could simply reserve its position on jurisdiction in general terms at the start of an adjudication, participate fully in the process and then, having lost the adjudication, raise a jurisdictional point to resist enforcement of the adjudicator's decision. A challenge to the adjudicator's jurisdiction should be made "appropriately and clearly" and preferably on the basis of a specific objection or objections, rather than as a general reservation of position.

The Court's decision

The judge considered that whilst the payment of an adjudicator's fees might amount to an election to treat an adjudicator's decision as valid, here it would be wrong to do so. The judge distinguished Coulson LJ's judgment in *Bresco* on the basis that in *Bresco* general and unspecified objections to the jurisdiction of an adjudicator were made during the course of the adjudication.

In this case, ISG's complaint was a complaint of breach of natural justice which was and could only be made at the conclusion of the adjudication, after the decision had been made. ISG had made it clear that it was reserving its position when the payment of fees was made.

The judge also stated that as a matter of public policy, it would be incorrect to discourage payment of adjudicator's fees if payment of those fees were to amount to a waiver of the right to challenge the adjudicator's decision.

The Court went on to consider ISG's enforcement challenges and rejected them all. Although ISG had not waived its right to challenge the adjudicator's decision, its challenges failed.

Going forward

If reserving the right to challenge an adjudicator's decision, you should be mindful of when to do so and should avoid making a general reservation at the commencement or during the course of an adjudication. Instead, you should reserve your right to challenge the adjudicator's decision on the basis of appropriate and specific objections. These are likely to arise following the conclusion of the adjudication after the decision has been made.

Summer 2020

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HMRC's crackdown on contractors: IR35 changes

As many businesses and contractors, including those in the construction sector, will be aware, the Government is planning to introduce wide-ranging reforms to the off-payroll working rules (commonly known as "IR35" or the "intermediaries' legislation").

Hugh Gunson
Legal Director
Corporate Tax

These changes represent a significant shift in the tax and compliance landscape for businesses that engage workers through personal service companies (**PSCs**). Broadly, the changes mean that the reforms introduced in 2017 for the public sector will also apply for large and medium-sized enterprises in the private sector – so that the burden of tax and compliance is shifted from the PSC/off-payroll worker to the fee-payer or end-user client organisation. There are further important changes to the rules which apply to the public and private sector alike.

The changes were originally due to be implemented with effect from 6 April 2020, but on 18 March 2020 the Government announced that the implementation of the reforms would be postponed to April 2021 in recognition of the impact COVID-19 was having on businesses.

This postponement gives affected businesses more time to prepare, but importantly it is only a postponement. Whilst there are other immediate concerns given the current situation, businesses should not lose sight of the impending reforms, in particular as the April 2021 start date approaches. It appears that the Government is determined to proceed, even despite criticisms following an inquiry by the House of Lords Economic Affairs Committee. It has said it will commission further research into the long-term effects of the reforms in the public sector, with the intention that this will be available before they take effect in the private sector. As a result, further developments cannot completely be ruled out, but what is clear in the meantime is that the reforms will be going ahead.

In this regard, on 18 May 2020, the Government proposed amendments to include the draft IR35 legislation in the upcoming Finance Bill 2020. This is substantially the same as the previous draft legislation published in July 2019, with changes to reflect amendments announced since that date. Detailed guidance has also been published by HMRC (currently in draft form) in its Employment Status Manual.

This article provides both an overview of the IR35 reforms as set out in the draft legislation and sets out some practical guidance for affected businesses.

Background

Broadly, the IR35 rules catch arrangements where the following three conditions are satisfied:

- an individual personally performs services for a client;
- the services are provided not under a contract between the individual and the client but rather between the client and a third party (typically a PSC, though this can include other entities); and
- if the services were provided under a contract between the client and the individual, the individual would be regarded as an employee for tax purposes.

This could potentially apply to anyone involved in a construction project, from architects to security guards (and many more besides), whether they are engaged directly or through a labour or recruitment agency.

The rules are basically designed to catch disguised employment relationships through PSCs. The key point of contention is often the third condition – i.e. whether the worker would be treated as an employee for tax purposes. There have been a number of cases before the tax tribunals in recent years focussing on this particular point. A recent case involved an individual who provided construction management services (including night shift management) to construction companies – albeit he successfully argued that IR35 did not apply. This aspect of the rules is not explored further in this article – save to note that it requires a detailed examination of both the relevant contractual arrangements and the actual working practices of the worker.

If IR35 applies, the worker is deemed to be in receipt of a payment of earnings, with a consequent obligation to account for income tax through PAYE and NICs. Historically, the PAYE obligation fell on the PSC for all engagements within the scope of IR35.

However, in 2017, the rules were amended for engagements where the end-user/client was a public authority (primarily public authorities subject to the *Freedom of Information Act 2000*). For such engagements, it was the responsibility of the client public authority to determine whether IR35 applied, and the PAYE/NICs liability was shifted to the "fee-payer" (i.e. the entity paying the PSC) – which could be the client, or, in a more complex labour supply chain, the agency procuring the services of the worker.

The Finance Bill 2020 changes

Following a lengthy consultation process, draft legislation recently introduced in the Finance Bill 2020 includes provisions rolling out the public sector changes to the private sector with an implementation date of 6 April 2021. The changes apply broadly for services provided from 6 April 2021 onwards, regardless of whether the relationship was originally entered into before or after that date. If all the services are provided before that date the changes do not apply to a payment regardless of when it is made. If payment is made in relation to services made both before and after 6 April 2021, then a "just and reasonable" apportionment is required.

Who is affected?

The changes only apply where the client is not "small". HMRC say this means they will not affect the vast majority of organisations who engage contractors through PSCs.

For companies, "small" is determined in the same way as for the *Companies Act 2006*: i.e. currently where 2 or more of the following conditions are satisfied:

- the annual turnover is not more than £10.2 million;
- the balance sheet total is not more than £5.1 million; and
- the number of employees is not more than 50.

There are further detailed provisions for determining "small" in the context of groups of companies, joint ventures, subsidiaries, limited liability partnerships, unregistered companies, overseas companies and other persons. There is also an obligation on businesses to respond to information requests regarding their size from contractors or their agents within 45 days, with the possibility of court orders to enforce compliance.

The upshot is that where the (private sector) client is "small", the old rules still apply – i.e. the responsibility for determining whether IR35 applies and any consequent tax liability remains with the PSC (or other relevant intermediary). However, where the private sector client is medium or large, the burden switches to the end client and/or the fee-payer (if different).

How do the new rules work?

The basic purpose of the new rules is to align the treatment for medium and large private sector organisations with that of the public sector. However, further changes have been made, which apply to public sector and private sector arrangements alike.

The first step is to identify the chain of two or more persons involving the client at one end and the PSC at the other, where each person in the chain makes a payment to the next person which represents payment for the worker's services.

If the IR35 rules apply, then the *fee-payer* (i.e. the person making the payment to the PSC) is treated as making a payment of earnings to the worker, and consequently is required to operate PAYE.

So, in the most simple scenario, the chain involves an end-user client contracting directly with a PSC (and paying it direct), in which case the client is required to determine the IR35 status and operate PAYE. If the chain is more complex (i.e. involving one or more labour or recruitment agencies between the client and the PSC), then the client is still required to determine

Summer 2020

Construct.Law

the IR35 status, although the PAYE obligation falls on the agency that actually pays the worker.

In the construction industry, it is suggested that this "chain" would begin with the main contractor (and not, for example, the ultimate client that has engaged the main contractor to carry out the relevant project) and end with the PSC. The main contractor would therefore be the "client" / "end-user" for IR35 purposes. The main contractor may engage the PSC directly, or there may be one or more labour or recruitment agencies involved in between. The main contractor may of course sub-contract out elements of the work – the sub-contractors (and sub-sub-contractors etc) would then potentially find themselves at the head of chains involving PSCs and so would also need to consider the application of the rules. HMRC's draft guidance addresses the application of the new rules to "contracted-out" serves (though not specifically with reference to the construction sector) – this can be found here.

Status determination statement

The new rules introduce the concept of a "status determination statement" or "SDS". This will be a key compliance issue for construction companies, and applies equally to public sector and medium/large private sector arrangements.

The SDS is a statement to be given by the *client / end-user* (i.e. the construction company at the head of the chain), which in practice will be required in respect of every engagement potentially within scope of IR35. It must contain two main things: (i) the company's conclusions as to whether the employment status limb of IR35 is met (i.e. whether the individual would be regarded as an employee for tax purposes if his/her services were provided directly under a contract between him/her and the client); and (ii) the reasons for that conclusion.

The rules effectively contain an explicit requirement for the end-user construction company to take reasonable care in coming to the conclusion in an SDS (as if they fail to do so, the client is treated as not having made an SDS, with the negative consequences outlined below). It seems likely that this provision has been included at least in part in response to concerns raised during the consultation process that organisations would simply impose blanket IR35 status determinations on all of their contractors performing similar roles. In their Employment Status Manual draft guidance HMRC set out their views on what constitutes "reasonable care" including various examples.

HMRC are also promoting their Check Employment Status for Tax (CEST) services as a tool for making status determinations and include this as an example of taking reasonable care in the guidance referred to above. HMRC state generally that they will stand by the result given by CEST provided the information inputted is accurate and it is used in accordance with their guidance. HMRC updated their CEST toolkit following criticism that it lacked sophistication and provided new guidance on doing so. The updated version has still been subject to criticism though – in particular on the basis that it does not deal fully and accurately with the "mutuality of obligation" requirement. A number of recent cases (for example the Upper Tribunal decision in *HMRC v Professional Game Match Officials Ltd* [2020] UKUT 147) have indicated that HMRC's views on this issue are not correct – this should be borne in mind in relevant cases when using the CEST tool.

What does an end-user construction company do with the status determination statement?

Once the end-user construction company has made its SDS, it must pass this on to **both** the next person in the chain **and** also to the worker. If everything works correctly, the intention is for the SDS to cascade its way down the labour supply chain until it reaches the fee-payer (whose responsibility it is to operate PAYE).

In terms of timing, for ongoing contracts this should be done before the due date for the first payment under the contract on or after 6 April 2021. For new contracts the status should be determined before services are performed and ideally before the contract is signed.

If the SDS is given by the end-user construction company but not passed down the chain, then the PAYE liability sits with the party at fault.

Even where the SDS is correctly passed down the chain as envisaged, there are further provisions which give HMRC the power to pursue the end-user client for unpaid PAYE and NICs, where HMRC consider there is no realistic prospect of recovery from the fee-payer within a reasonable time. HMRC appear to have a wide discretion as to when to exercise this power, albeit the technical note accompanying the draft legislation states that they will not do so "in the case of genuine business failure of the party ordinarily liable for income and NICs".

It is clear that the purpose of these transfer of liability provisions is to drive up compliance within labour supply chains. The first agency and the client (i.e. the construction company at the head of the chain) are considered to be the parties who are best placed to influence and improve compliance within the whole chain.

The draft Employment Status Manual contains guidance from HMRC on steps businesses can take to help secure their labour supply chains.

HMRC has also confirmed it will take a light touch approach towards penalties in the first year except in cases of deliberate non-compliance.

Client-led disagreement process

The new rules also introduce a client-led disagreement process.

This gives a worker (or the fee-payer required to operate PAYE) the right to make representations to the end-user construction company that the conclusion in an SDS is incorrect. The end-user then has 45 days to consider the representations and communicate its conclusion (together with reasons, if it does not change its mind). If the end-user does not do this, then it becomes liable for PAYE/NICs.

This is presented as a protection for workers against blanket status determinations, which it is to an extent. However, the obligation on the end-user remains fairly light. End-users are only required to consider representations and give their conclusions, plus reasons. So if a worker continues to disagree with the end-user's re-considered status determination,

it has no further recourse or mechanism to challenge under the IR35 rules.

Of course the correct status under IR35 is a matter of fact and law, so a determination by an end-user is not binding on HMRC. A worker may therefore have additional avenues of challenge. In certain circumstances a PSC may have a contractual claim against an end-user (or fee-payer) on the basis that it has wrongly withheld amounts that were due to it. There may, however, be a number of difficulties in practice with such a claim (not least if there is an ongoing relationship). An individual may also be able to take up the point with HMRC through his or her own self-assessment process – in which case the client may find itself drawn into the matter. This has the potential to give rise to a significant number of disputes in future – and the exact ramifications will only be seen once the reforms take effect.

Finally, HMRC have been at pains to stress that the reform is not retrospective. They have stated that they will not use information resulting from the reforms to open investigations into PSCs for past years unless there is reason to suspect fraud or criminal behaviour. HMRC state: "This should provide reassurance to individuals that any change in status as a result of the reform will not lead to HMRC opening a historic enquiry." This does provide a level of practical comfort to workers and PSCs; however, it should be remembered that this is only HMRC guidance and the ability to rely on it in the event of a change of policy or practice by HMRC may be limited.

International aspects

The most recent draft legislation includes provisions which limit the scope of the new IR35 reforms to end-users / clients with a "UK connection". That is, the changes will not apply to end-users / clients who are neither UK tax resident nor have a permanent establishment in the UK. In such a case, the existing rules apply, and any payroll obligations under IR35 fall on the PSC.

However, where the end-user construction company is part of a group of companies, it is the whole worldwide group that needs to be taken into account for the purposes of determining whether the end-user is "small" (and not just the UK part).
The position where the worker and/or the PSC are non-UK can be more complicated. It will require consideration of whether the worker is within the charge to UK tax and/or NICs and the amount of work done in the UK; and may well also require consideration of any relevant double tax treaty.

Summary of new rules

In summary, the new rules represent a major change – and potentially a major compliance issue – for medium and large private sector organisations, including construction businesses that engage individuals through PSCs. Previously such organisations had been able simply to pay amounts gross for work done by such contractors, safe in the knowledge that any PAYE risk sat with someone else. However, that is no longer possible. Businesses will need to give proper consideration to the employment status of all PSC contractors, both existing and new, and will need to update their systems and processes accordingly. They should bear in mind that HMRC see the new rules as being a key tool for correcting compliance failures and are anticipating a significant increase in tax take as a result.

What should affected construction businesses be doing to prepare for the changes?

Affected construction businesses should ensure they are prepared for the introduction of the new rules in advance of the planned April 2021 start date. Many businesses have already done significant work prior to the recent deferral – they should ensure that all their preparation is completed (and they have reflected any

recent changes, e.g. in their workforce or working practices) before next April. Even in the current climate, HMRC are likely to focus on reviewing compliance once the new rules take effect (and may have limited sympathy if work has not been done in time, particularly given the recent deferral).

Set out below is a (non-exhaustive) list of steps affected construction businesses might consider taking by way of preparation. There is no "one size fits all" approach here though. Each affected business should consider carefully the steps that are appropriate to it, depending on various factors, such as the size of its contractor workforce and commercial priorities.

- To the extent this has not been done already, consider forming a cross-functional IR35 project team (across the various relevant functions, e.g. HR, legal, finance, tax and procurement) to manage the upcoming changes and work towards implementation.
- As soon as possible, undertake a full audit of the status of existing workers whose contracts extend beyond the April 2021 start date. The first step is to identify those workers who contract through PSCs (or other intermediary entities). The status should be reviewed by reference to both the relevant contractual terms and the actual working practices of each worker. If an audit had already been undertaken in the run up to April 2020, this should be reviewed to ensure it reflects any subsequent changes in the workforce or working practices.
- As a result of this review, businesses may find that some workers are clearly caught by IR35, while others are clearly not. For those that are caught, consider whether the simplest thing is to bring them onto payroll (though consideration should also be given to any employment law consequences). A number of workers may be of more uncertain status – in which case, consider whether genuine changes to working practices might be able to take them more clearly outside of IR35.
- Once the audit exercise has been carried out, businesses will also need to manage how the results are communicated to workers. Individuals may understandably be worried about this, as switching to PAYE could reduce their take-home pay significantly. It is important to be transparent and ensure that the workers are fully informed and understand how seriously the reforms are being taken. Businesses should show that they are considering each individual case on its merits and not just imposing blanket determinations on similar groups of people.
- It is inevitable, however, that some workers may disagree with status determinations. Put in place a process for dealing with this.
- It may also be advisable to audit current engagements with intermediaries and agencies that are used for the supply of workers. Businesses will need to be confident that each party in the supply chain has robust procedures and processes in place.
- Undertake an assessment of the financial impact of the new rules and increase budgets appropriately.
- Going forward, review current HR, procurement and other processes and procedures for onboarding workers, in particular to build into that an assessment of the IR35 status.
- As part of this exercise, review standard form contracts and consider whether any changes are required. It may be necessary to implement a formal dispute resolution procedure (perhaps with named people in the business being responsible).
- Build into all engagements a process for review of the IR35 status at particular intervals. Given that IR35 status can depend so heavily on what actually happens in practice, as a relationship with a worker develops over time, the real position may be different from that envisaged at the outset.
- Take into account HMRC's guidance on practical issues in the draft Employment Status Manual Guidance.

While the IR35 changes are not exclusive to the construction sector, they are likely to affect many organisations within the industry and businesses which may be affected should consider their contracting structures and supply chains.

Drones in construction – designing for urban air mobility

The use of unmanned aerial vehicles (UAVs) or drones, as they are more commonly known, as data collection platforms to service a diverse range of civilian and commercial uses is an area that has grown rapidly in recent years. This has been aided by a decrease in the cost and an increase in the reliability of the technology. It continues to be an area of extensive research and development.

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In the current time of restrictions on site activities and methods of working, the use of drones for inspection is likely to increase. While data collection is a common and continuing use of drones in the construction industry, their potential goes much further.

Data collection in the construction industry

The current benefits of drones include relatively easy access to large or difficult sites and tall or complex structures, coupled with low set up costs when compared to the traditional use of cherry pickers or scaffolding to access difficult areas. The ability to operate drones remotely also increases safety on site.

The use of drones for data collection before, during and after the construction phase includes:

- **Building surveys and maintenance:** Performing a building survey using a drone can save time and money. 3D images can be produced and processed more efficiently and access can be gained more easily and safely to difficult and spatially challenged sites using drone technology as compared to the limitations posed by physical inspection. Early faults and wear can be more quickly and economically identified saving potentially costly repairs or replacement.
- **Health and safety:** Site plans can be quickly and efficiently updated to show where different works are taking place, making it much easier to convey this information on a regular basis to site operatives.
- **Progress tracking and reporting:** Progress reports are usually prepared weekly or monthly to record site progress against the project programme. These usually involve the surveyor or contract administrator taking multiple photographs of different parts of the site. Using a drone regularly can provide a faster and more effective way of recording project progress, freeing up the contract administrator's time and giving employers a quick update on how works are proceeding. The drone can fly the same path multiple times a day to create time lapse images for comparative analysis and provide detailed maps of the entire project with GPS points, which allows review of a particular part of a site in minute detail. This may assist in identifying any problems at an early stage and possibly before they become costly or delay the programme. Further, the retention of such detailed records may reduce disputes as the contractor is able to demonstrate the rate of progress with the requisite records.
- **Security:** Sites can be continuously monitored by drones from a range of locations and viewpoints, allowing increased security to protect materials and reduce the risk of trespassers. Not only does this give the parties peace of mind but it can reduce the cost of security.
- **Building Information Modelling (BIM):** Drones can quickly collect high resolution images to input into PC or cloud based photogrammetry systems to produce 3D maps and point clouds. The aerial perspective and digital data provides greater consistency and data density for use in BIM.
- **Monitoring environmental factors:** Sensors can be mounted on drones to allow monitoring of environmental factors. For example, in areas of contaminated land, hyperspectral sensors which are used for hyperspectral imaging (imaging which collects and processes information from across the electromagnetic spectrum) can be used to detect soil contamination.

Urban air mobility

As well as utilising drones to support the construction stage, a key consideration for buildings and their design both now and in the future is how they will fit into a world with increasing urban air mobility.

With increasing traffic congestion and pollution, and with ground based infrastructure stretched beyond its capacity and expensive, sometimes impossible, to improve, it is not surprising that delivery service providers have investigated how they might use urban air mobility and drone technology to supplement traditional forms of transport.

The integration of flexible take-off and landing infrastructure in major cities around the world will be crucial for the success of urban air mobility. The world's first full scale air taxi, VoloPort, was unveiled in Singapore at the end of last year. While a passenger taxi service is still some time away, testing is underway. It is an indication of things to come and buildings need to be designed with an eye on these likely future requirements.

While developers and owners have been creating "smart buildings" to cater for the demand of modern society, they should also consider drone connectivity for the future. Adopting adaptable infrastructure in new buildings now may preclude expensive renovation works later. Future-proofing new developments in this way should certainly be considered in order to maintain – and hopefully enhance – the value of the investment.

Cargo handling

The number of parcel deliveries is continually increasing. In London alone, parcel deliveries increased by 65% between 2012 and 2016 and they are expected to grow by a further 33% by 2021. In the future, drones may be used to assist in cargo handling, reducing time and risks associated with the delivery of materials.

Cargo drones are already operating successfully in China, Switzerland and Africa – with a particular focus on medical deliveries. UK based drone infrastructure and operating company Skyports are conducting flight trials in the UK, Finland, Belgium and Sweden. Drones are faster and offer reduced carbon dioxide emissions consistent with the need to reduce the environmental impact of the forms of transport on which we currently rely.

It is likely that drone delivery of certain materials to site will not be the most economical model given their size and weight. However, drones may be used for delivery of some materials, including modular items. They may also be used as a means to inspect cargo deliveries when they reach site to ensure the delivery accords with the orders placed.

What's next?

Drones have the potential to bring great benefits. In its report on drones, *Skies without limits*, PwC predicts that the industry will contribute an extra £42 billion to the UK by 2030. How we utilise the drone technology that exists and develops in the future will have a significant impact on the benefits they could bring. This must be balanced with the risks of using drones, as shown by recent reports of near misses with aircraft.

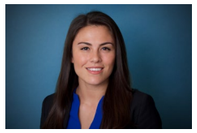
There is a regulatory framework for anyone using a drone on a construction site, although in some respects the law is "playing catch-up", rather than proactively anticipating the legal issues that will arise. This article does not address the regulatory framework for flying drones in the UK.

It is clear that the use of drones will continue to increase in the construction industry. There are potentially significant cost, time and safety benefits in using this technology and it will be interesting to see how the use of drones and the law surrounding them will develop in the future.

This article was first published as a blog by Practical Law Construction on 5 May 2020.

Home owner warranty claims: when does the clock start ticking?

A claim against a home warranty insurer has been dismissed by the TCC on the basis that the property owners' claim was not brought within the required time and was therefore statute barred under section 5 of the *Limitation Act 1980*.



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The TCC's decision in *Griffiths v Liberty Syndicate 4472* [2020] EWHC 948 (TCC) reiterates the position that the period during which a claim must be brought commences when an insured loss is suffered as the result of the occurrence of an insured event, unless there is express wording to the contrary in the home warranty policy.

The background

In 2007, a former factory was converted into 225 apartments. The common parts comprised an atrium with a glass roof and a rooftop outdoor space with a running track and barbeque area.

Mr and Mrs Griffiths were long term leaseholders of one of the apartments in the development and alleged that the common parts were defective in two respects: (1) open louvres in the atrium let in rainwater which caused structural damage, and (2) a membrane surrounding the atrium had been cut in the course of construction allowing water ingress.

The Griffiths, along with other leaseholders within the development, were insured under a housing insurance policy underwritten by Liberty. The policy provided for defects and structural insurance, covering the period from May 2009 to May 2018.

It was accepted by the parties that the developer and Liberty had been notified of the atrium defect by the management company on behalf of the Griffiths and other leaseholders in March 2010, and that Liberty rejected the claim in June 2011. Liberty argued that the roof defect was also discovered in or before March 2010, a fact that was not disputed by the Griffiths.

The dates on which the defects were discovered is relevant as section 5 of the *Limitation Act 1980* states that a claim based on a contract, such as in this case, must be brought within six years of the date on which *"the cause of action accrued"*.

Despite both defects being discovered in or around March 2010, the Griffiths and others commenced proceedings on 4 January 2019, nearly 9 years after discovery of the defects. It was agreed by the parties that if liability under the policy had accrued before 5 January 2013, six years before the proceedings commenced, the claim would be statute barred pursuant to section 5 of the *Limitation Act 1980*.

The parties' positions

The Griffiths argued that they notified Liberty of the defects during the period that the defects and structural insurance cover was in place, but the terms of the indemnity in the policy did not trigger an entitlement under the policy unless and until the Griffiths had incurred the costs of rectifying the defects. Therefore, as Liberty's liability to indemnify under the policy did not arise until the Griffiths had incurred rectification costs, time had not started to run for limitation purposes. The specific date on which the Griffiths incurred the cost of rectifying the defects is not stated in the judgment, but presumably it was after 5 January 2013 and within six years of the commencement of the proceedings.

Liberty, on the other hand, argued that the defects were discovered in or before March 2010 and this was when the limitation countdown commenced. Accordingly, the Griffiths had brought their claim outside the six year statutory limitation period and were out of time.

The decision

The Court rejected the Griffiths' arguments that liability only accrued under the policy when costs were incurred in rectifying defects.

The Court held that:

- To achieve what the Griffiths contended, clear words to that effect would be required in the policy. In the absence of clear words to the contrary, liability immediately arises under a policy of indemnity insurance, such as in this case, when an insured loss is suffered as the result of the occurrence of an insured event. Although the insurer has the option as to how to return the insured to its pre-loss position, this does not prevent or delay the insurer from being liable to immediately indemnify the loss.
- If the Griffiths' proposition was accepted, it would result in the insured party always being able to control the date at which time starts to run. Clear words are required before a party is considered to have control over when time starts to run against it, as this is such an unlikely provision for the other party to have agreed.
- Interpretation of a policy in this way would defeat the purpose of the policy, as rectification works may never be carried out where it was too expensive to do so, such that the insured would never incur a liability under the policy.

Impact of the decision

The Court's decision in this case is not surprising. To have accepted the Griffiths' contention that the clock starts ticking only when a party incurs costs in rectifying a defect has the potential to see insurers avoid liability for rectification altogether where property owners cannot afford to rectify the works. It would have the potential to defeat the purpose of home warranty insurance, particularly where the cost of rectification is likely to be expensive and unaffordable without the benefit of a payment under the insurance policy.

However, it is a reminder that such insurance claims must be brought within six years of the loss being suffered. A claim will not be in time simply because it is made within the 10 year time period covered by the policy.

Summer 2020

Construct.Law

Indirect and consequential loss exclusions – is it time for change?

Parties to construction contracts often include clauses in their contracts seeking to exclude claims for indirect and consequential losses, believing that such clauses are likely to prevent claims for financial losses such as lost profits and business interruption. Contracting parties may consider such financial losses to be beyond the ordinarily recoverable losses flowing from a breach (as compared to the actual cost of repairing defects, for example). However, it is unlikely that such exclusion clauses will bar a claim for this type of financial loss.

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But is a change forthcoming? The TCC's recent decision in 2 *Entertain Video Ltd v Sony DADC Europe Ltd* [2020] EWHC 972 (TCC) suggests judicial appetite for a change to the traditional and narrow interpretation of indirect and consequential loss exclusion clauses. Although the court's decision accorded with the traditional interpretation, O'Farrell J considered that indirect and consequential loss exclusion clauses should be given their natural and ordinary interpretation while considering the contract as a whole and any relevant factual matrix.

Background to the traditional approach

There is a line of cases that establish that a contractual exclusion for consequential and indirect losses is limited to losses which fall within what is known as the second limb of *Hadley v Baxendale* (1854) 9 Ex 341. *Hadley v Baxendale* is an old and well-known case that established the remoteness test for recoverability of damages for breach of contract. The two limbs are:

Limb 1:
damages that arise naturally from the breach, in the ordinary course of things (direct losses).

Limb 2:
damages that may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, arising as the probable result of the breach (indirect or consequential losses).

Loss of profit will not inherently be categorised as an "indirect or consequential loss" such that it may be caught by an exclusion clause for such losses. Financial losses, including loss of profit, which one would normally expect to flow from the breach, are likely to be classified as direct loss.

By way of example, in *Croudace Construction Ltd v Cawoods Concrete Products Ltd*, the judge at first instance (whose decision and reasoning was upheld by the Court of Appeal) held that the word "consequential" did not cover any loss that directly and naturally resulted in the ordinary course of events from late delivery of masonry blocks for a construction project. The contract provided that the suppliers of the masonry blocks were:

"Not under any circumstances to be liable for any consequential loss or damage caused or arising by reason of late supply ...."

The judge held that losses that began to *"clock up at once"* (such as the wasted cost of the workforce, plant and equipment) were to be regarded as direct and not consequential loss. The loss was considered a direct and natural consequence of the breach and was recoverable notwithstanding an exclusion clause precluding recovery of consequential loss. Therefore, commercial parties should be wary when drafting their exclusion of loss clauses.

Moving away from the traditional approach?

Notwithstanding this, a combination of developments in the general principles of contractual interpretation, together with the courts taking a more flexible approach indicate that courts may now be moving away from the traditional approach.

In *Transocean Drilling UK Ltd v Providence Resources plc*, the Court of Appeal stated in respect of consequential loss:

"It is questionable whether some of ... [the past] cases [such as Croudace Construction v Cawoods] would be decided in the same way today, when courts are more willing to recognise that words take their meaning from their particular context and that the same word or phrase may mean different things in different documents."

In *Transocean*, "consequential losses" were defined in the contract as:

"(i) any indirect or consequential loss or damages under English law, and/or

(ii) to the extent not covered by (i) above, loss or deferment of production, loss of product, loss of use ... loss of business and business interruption, loss of revenue ... loss of profit or anticipated profit ..."

The Court of Appeal did not consider it necessary to categorise the losses as ones that fell within one or other of the limbs of *Hadley v Baxendale*. Instead the court's starting point was the language of the clause itself and the natural meaning of the words:

"...the court's task is not to re-shape the contract but to ascertain the parties' intention, giving the words they have used their ordinary and natural meaning."

Similarly, in *Star Polaris LLC v HHIC-Phil Inc*, the court concluded that although the meaning of "consequential loss" in an exemption clause usually meant the exclusion of losses falling within the second limb of *Hadley v Baxendale*, in the absence of judicial consideration of the particular clause in question, it should be construed on its own wording in the context of the particular agreement as a whole and its particular factual background.

In *Star Polaris*, the shipbuilder had expressly agreed to repair or pay for physical damage and some identified consequent expenses. It was common ground that the liability provisions of the contract provided a complete code for damages. The court held that, by excluding liability for "consequential or special losses, damages or expenses", the parties intended to exclude all financial losses, consequent on physical damage that had not expressly been accepted.

The facts of 2 Entertain Video Ltd v Sony DADC Europe Ltd

2 Entertain Video Ltd (**2E**) issued proceedings claiming, among other things, loss of profit and other business interruption losses against Sony arising from a fire which destroyed Sony's warehouse following the civil disorder and riots in London in 2011.

At the time of the fire, Sony provided logistic services and warehouse storage facilities to 2E who stored stock valued at approximately £40 million. The parties' contract included the following exclusion clause (clause 10.3):

"Neither party shall be liable under this Agreement in connection with the supply of or failure to supply the Logistics Services for any indirect or consequential loss or damage including (to the extent only that such are indirect or consequential loss or damage only) but not limited to loss of profits, loss of sales, loss of revenue, damage to reputation, loss or waste of management or staff time or interruption of business."

The decision

The court looked first at the ordinary and natural meaning of the *"unhappily drafted"* provision. It considered that the second part of the clause was not helpful even though it sought to provide an indication of categories of loss that the parties sought to exclude because "loss of profits" and the other stated categories of loss were losses that may or may not fall within the exclusion.

Sony argued that the combination of clause 10.1, which provided that Sony's liability for any loss of or damage to 2E's materials or goods *"shall not exceed their manufacturing replacement cost"* and clause 10.3, the consequential loss exclusion, constituted the complete contractual scheme of risk and liability allocation:

- Clause 10.1 identified the particular loss for which Sony would be liable and defined the limit of such liability.
- Clause 10.3 excluded the lost profits and business interruption losses claimed by 2E as these were **consequential** on the loss of the goods.

It relied on *Transocean* and *Star Polaris* in support of this interpretation.

The court disagreed noting that:

- Unlike the provisions in *Star Polaris*, clause 10.1 did not attempt to define the extent of Sony's liability for all breaches under the contract. It was simply concerned with compensation for the loss of, or damage to, the goods. It did not preclude a claim for lost profits and other business interruption losses and did *"not assist in ascertaining the true meaning of clause 10.3"*.
- There was no definition of indirect or consequential loss in the contract as there was in Transocean that would suggest a wider meaning than the second limb of *Hadley v Baxendale*.

The court agreed with Sony's submission:

"...that any general understanding of the meaning of 'indirect or consequential loss' must not override the true construction of that clause when read in context against the other provisions in the [contract] and the factual matrix."

However, it concluded that clauses 10.1 and 10.3 could not be interpreted in the way suggested by Sony to exclude the loss of profits and business interruption costs claimed by 2E. These losses flowed directly and naturally from the fire and from Sony's breach in failing to provide the logistics services.

Going forward

Although the court thought the way in which the exclusion clause had been drafted in this case was unhelpful, it considered the words in the contract and the surrounding facts, giving the words "indirect and consequential loss" their natural and ordinary meaning.

Parties should consider carefully the drafting of any exclusion clauses and the types of losses they are trying to exclude. Financial losses, such as lost profits and business interruption costs (as in this case), may not necessarily constitute indirect or consequential loss or damage and, as a result, may not be captured by a generic description of categories of loss.

To what extent will the courts continue to uphold the traditional interpretation? Given that judicial commentary in a number of cases over recent years has suggested a change in approach, it will be interesting to see whether the courts will adopt a case-by-case approach when interpreting such exclusion clauses going forwards.

This article was first published as a blog by Practical Law Construction on 19 May 2020.

Essential law: Variations - Part one

In the first of a series on the basics of construction law, James Worthington and Vanessa Jones begin with variations, considering here the scope of the right to instruct variations.

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The variations regime is fundamental to both parties to a construction contract. It gives the employer the flexibility to change the works, and determines the extent to which the contractor will be allowed additional time and money for such changes.

This article will look at some of the issues regarding the extent of the employer's right to instruct a variation and the contractor's right to claim that an employer's instruction is a variation.

What is a variation?

Most construction contracts will include a definition of what is a "variation" under that contract. In general terms, a variation is an instruction by the employer to alter the works to be performed or an instruction to vary their timing, method or sequence.

However, not all instructions will be treated as variations. In particular:

- Where the instructed work is "indispensably necessary" to complete the contract works, the court will generally infer that it is included in the contracted works, regardless of the fact that it is not expressly identified in the specification.
- Where the contractor has agreed to design and build a facility to meet certain performance specifications, changes to the design required to meet those performance specifications will generally not be a variation.
- Where the contractor has taken on a risk under the contract (such as ground conditions), any delay or additional cost that arises from that risk will be the responsibility of the contractor, and will generally not be a variation even though the methodology required to complete the works may have changed.
- Where the contract gives the architect the power to determine the method by which the works are executed, it is generally not a variation if the architect chooses a specific methodology, even if that choice was unreasonable.

Can an employer instruct any variation?

There are certain limits on the employer's right to instruct a variation that will generally be implied into a construction contract, such that the following are not permitted (unless expressly permitted by the contract or agreed by the contractor):

- Instructions that fundamentally change the nature of the contract, or were clearly not contemplated by the original contract. The guiding principle is that after such variation the works should still be capable of being identified as the works originally defined in the contract.
- Instructions that omit works for the purpose of awarding those works to another contractor. If an employer intends to omit work, it should be for the purpose of omitting that work entirely from the project. The courts have held that a contractor has both an obligation to do the works, and a corresponding right to be able to do those works.
- Instructions after practical completion has already occurred.

Does the contractor have the right to carry out additional work?

A contract may give the employer the right to instruct additional work, but that does not mean there will be an implied term that if additional work is required, the employer must instruct the contractor to carry it out.

Can the contractor object to a variation?

This would depend on the terms of the relevant variation clause. However, the standard forms generally contain a limited right for the contractor to object. For example, JCT provides that a contractor may make a reasonable objection to an instruction that relates to the imposition by the employer of any restrictions regarding access, limitations of working space or working hours or the execution of work in a specific order.

Are there circumstances where an employer is obliged to instruct a variation?

Certain standard form contracts (such as the old ICE conditions) place a positive obligation on the engineer to instruct a variation if this was necessary for completion. However, whether such an obligation may be implied is more complex. There is a tension between the contractor's obligation to build what is described in the contract even if that is impossible, and the implied duty on the employer to co-operate.

What if there is no variation clause?

All standard form construction contracts contain variation clauses, but what if the parties have contracted on, say, a simple agreement of price and scope of work without a variations clause?

First, there is no implied right for an employer to instruct a variation under a construction contract. Therefore if there is no express contractual right for an employer to instruct variations, the contractor can refuse to carry out such variations without consequence.

Second, if the contractor agrees to carry out such variation, this varied work may be construed as a new contract such that the varied work is valued on a different basis than under the original contract and not based on the rates and prices in that original contract.

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Essential law: Variations - Part two

Continuing our series on the basics of construction law, Sara Cunningham considers some of the issues that can arise when valuing variations under a construction contract

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Associate
Construction

Variations may give rise to additions or deductions from the contract sum and may also require an adjustment to the completion date, depending on the nature and scale of the variation. The key starting point when valuing a variation is the terms of the relevant construction contract.

How are variations valued?

Generally speaking, there are two approaches to the valuation of variations:

- Using contractual rates
- Valuing on a cost basis.

Different standard forms take different approaches. For example, the JCT forms generally seek to value variations using the contractual rates, whereas the NEC forms generally seek to value variations on a cost basis.

Using contractual rates

Valuing variations is most often based on the rates and prices in the contract. For example, the valuation rules in the JCT design and build form provide the following process to value variations:

- Where work is of a similar character to work in the contract documents, then the valuation shall be consistent with the relevant values in the contract sum analysis.
- There will be a due allowance for any change in the conditions under which the work is carried out or the quantity of the work, together with an allowance for any addition or omission of design work and for any change to the provision of site administration, site facilities and temporary works.
- Where the work cannot be valued on the above basis, the valuation can be carried out on a time and resource basis – in other words, a dayworks valuation.
- In so far as a dayworks valuation cannot be made, a "fair" valuation is to be made.
- In so far as a variation leads to a substantial change in the conditions under which any other work is executed, that other work shall also be treated as varied and valued in accordance with the above principles.
- Any effect of the variation on the regular progress of the works is to be ascertained separately under the loss and expense clause.

Valuing on a cost basis

An alternative approach is to value variations on a cost basis.

For example, the NEC contracts do not value variations (one of the compensation events under the NEC forms) by reference to the contract prices. Instead, they are valued by:

- Assessing the effect of the variation on the defined cost (not actual cost) of the works. This defined cost is assessed by reference to the relevant schedule of cost components, which sets out the items to be included in the defined cost. It is not necessarily the same as the actual cost incurred by the contractor in carrying out the variation.
- Adding a percentage uplift to that change in defined cost to represent the fee (meaning the contractor's overheads and profit).

This assessment is to include all the effects of a variation. In other words, there is no separate valuation of loss and expense resulting from any effect on the progress of the works.

Further, the parties can agree to use the contractual prices to value a variation if they consider that more appropriate.

Common issues

There are a number of issues that can arise when valuing variations:

- Should the valuation always include an allowance for overheads and profit? In *Weldon Plant vs Commission for the New Towns* (2001), the court considered a contract based on the ICE conditions and whether a fair valuation could be made that excluded an allowance for overheads and profit. The court held that a fair valuation had to establish which overheads were involved in the variation and had to include an element of profit in the absence of special circumstances.
- What if the contractual rates are too high or too low for the variation? If the contract provides that the variation is to be valued using these rates, this could lead to a windfall for one of the parties. This is one of the reasons the NEC adopts a cost-based valuation for variations – it is intended that no party should unfairly gain as a result of a variation.
- How should omitted works be valued? This will always depend on the terms of the contract. In *MT Højgaard vs E.ON* (2017), the court agreed with the contractor's argument that the omission should be valued by reference to the contribution of the omitted work to the total contract price. It rejected an argument from the employer that the valuation should be based on an estimate of what it would have cost the contractor had it carried out the works as originally planned.

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About the construction, engineering & projects group

We are a large team of over 40 specialist lawyers, based in 11 locations across the UK, Europe, the Middle East and Asia, enabling clients to access the full range of the firm's skills and expertise, both in the UK and internationally. The team includes dual qualified barristers and solicitors, engineers, and accredited mediators and adjudicators.

Our Construction, Engineering & Projects group provides the full range of dispute and transactional services for large scale construction and engineering projects, in the UK and internationally.

We act for a wide range of clients, but with a particular emphasis on:

- major contractors
- major engineering consultancies
- real estate developers
- housebuilders
- property investment companies

Our core transactional legal experience include advising on all forms of construction and engineering contracts and associated documentation, insurance arrangements, and all related financial security (such as bonds, guarantees and warranties).

Our dispute resolution experience is extensive, including advising on:

- court proceedings
- adjudication
- arbitration (domestic and international)
- expert determination
- mediation and dispute avoidance

We focus our dispute resolution strategy on maximising the net recovery for our clients when bringing claims, and minimising or extinguishing their exposure when defending them.

Our full-service approach ensures that an appropriate strategy can be adopted to achieve our client's priorities throughout the lifetime of a project. Our aim is to provide a personable and highly responsive specialist service.

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If you are interested in more information on anything you have read in this newsletter, please contact the relevant author, your usual Charles Russell Speechlys contact, or alternatively:

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