

**The New Economic Reality:
Implications for the Construction Industry in Hong Kong**

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Security for Payment

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SECURITY FOR PAYMENT

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Since I settled in the UK on my ostensible retirement from Hong Kong in 2001, one of the most frequent questions that I am asked is the extent of changes to Hong Kong since the “handover” or “reunification” at the end of June 2007. My short reply, omitting a lengthy discourse on the nature and definition of *change*, is that Hong Kong is a very fast changing sort of place which, of necessity over the years, has learnt to adapt itself to all manner of external changes and to turn these into opportunities – I also usually omit an unflattering comparison of the UK in this respect!

Over these two days we have been looking at aspects of the New Economic Reality as they impact on the HK construction industry, and have heard some interesting papers and discussions on both the general aspects (the NER itself and procurement methods) as well as specific and knotty problems – ground conditions/utilities and this final session topic – Security for Payment. Neil Kaplan has just given us a very literate and helpful presentation on disputes and the ever developing ways in which we seek to resolve them; and his concluding summary of the benefits of **early resolution of disputes** should resonate throughout the industry.

My thoughts on Security for Payment in this context are based on my own **experience** working in the construction industry in Hong Kong for 31 years, mainly on the Employer side, and subsequent good fortune to have acted as mediator in a significant number of construction mediations of all shapes and sizes, throughout the Region but principally here in HK.

My last ten years in HK were spent in three statutory bodies, effectively as head of procurement; I mention this because these organisations, which are common in HK and are for the most part government funded, have very different decision making processes in relation to treatment and settlement of construction disputes.

I am here addressing the more global point of **timely and fair payment to contractors** at all levels rather than the narrow issue in legal and arbitral proceedings of protection of a party against possible insolvency or other avoidance of tribunal awarded costs and payments.

Firstly some elementary principles. When a contractor (and I mean this to include sub-contractors and others further down the food chain) carries out work for an Employer he expects to be **paid the contracted sum, adjusted by the provisions of the contract for any changes**. He also expects to be paid in a timely manner, recognising that the construction industry by its very nature is very cash flow driven.

The proverbial man, or probably these days, woman on the Mong Kok omnibus, or indeed a visiting Martian or Martienne, would understand this and wonder why we are all sitting here devoting a huge amount of time and expertise to discussion of how to make these simple principles work.

When the late British Prime Minister Harold Macmillan was asked by a thoughtful interviewer on the greatest risk to the smooth operation and stability of his government he replied “**Events, dear boy, Events**”. Indeed, events coming out of a clear blue sky have brought down many promising political careers and even governments. This is also the case for construction contracts and projects – my simple phrase a few moments ago “contract sum, adjusted by the provisions of the contract for any changes” alludes to the changes, or events, that can bring down a contract in acrimony and dispute.

Many of us here, who deal with disputes on a regular basis, will also know that the most of the events that cause all this distress fall into a few simple and recurring categories

1. The **Employer’s requirements** which the contractor has contracted to construct or supply and install. These can be changed by the Employer or his agents, deliberately or accidentally. They can contain inconsistencies and errors or merely be provided late.
2. The **conditions** under which or within which the contractor is expected to carry out the work may be different or other aspects of the complex procurement and supply chain may not function as the parties anticipated at time of contract. Expected quality may not be achieved.
3. **External and unexpected events** such as weather or social or community issues such as strikes, legislation and regulation, or economic fluctuations may disrupt the work.

4. **Combination** – these events interact with others to compound problems

Construction is carried out in real time, so that any unexpected event will have an impact; even at working level, the parties often disagree on both the **responsibility** (hence the **payment liability**) for this impact and its **value** (both in time and cost). On a large contract I am accustomed to seeing several thousand such events of widely differing cause, size, scale and impact. Clarification of the causes and effects of these absorbs large amounts of time and effort causing money to leak away from the project – **this money does not return** and its cost is shared between the Employer and the various contractors depending on the outcome of whatever final negotiation or dispute resolution that the parties agree to apply to their differences.

This scenario is the **norm** for construction contracts, varying only as to the degree and scale of the issues in dispute. The industry as a whole, assisted by an equally large army of support professions such as lawyers and consultants constantly seeks the silver bullet to prevent this. These come in many forms ranging from **new procurement strategies** (discussed this morning) through **exotic contract forms** to the pragmatic recognition that disputes are unavoidable and focussing on more **effective dispute resolution methods** – as discussed earlier by Neil Kaplan.

In terms of new procurement strategies and “better” forms of contract I nail my colours to the mast. I believe that poor procurement procedures and contracts if capably **administered** can result in good project outcomes, and equally the most elegant procurement system with expensively developed “close-all-loophole” contracts if badly administered will end in disarray and multiple disputes.

Most improvements seek to minimise the inherent conflict of objectives between the Employer and the various contractors with the former seeking to minimise his payments and the contractors seeking to maximise their receipts; the problem is usually compounded by **human nature** and a natural tendency to partisan or tribal behaviour. Examples of procurement methods seeking to reduce this are the partnering or framework structures, although the latter seems to be falling out of favour in the UK. Contracts which minimise disputes seem to be those which achieve the fairest and most transparent **sharing of risk** between the parties, as for example the NEC seeks to achieve.

Dispute resolution methods also seek to reconcile conflicting needs, particularly for the contractor. There are the **final** determination procedures which should achieve thorough and final analysis of the issues but at a high cost in time and expense, and with risks of an outcome determined by superior firepower and the presentation of a story that bears little resemblance to the actual circumstances and issues at the time that the dispute arose.

The **preliminary** determination procedures avoid most of these problems if they are successful (however success is defined), but from the viewpoint of a contractor anxious to receive outstanding payment for work carried out some time previously they can suffer from their voluntary (i.e. avoidable) initiation requirements and lack of finality. Some lend themselves better to cost and time management than others.

Governments also are concerned with the effectiveness and solvency of their construction industries and are susceptible to lobbying from various sectors to improve their position. Statutory support for Arbitration, especially in terms of enforcement has been highly beneficial in many jurisdictions including Hong Kong, and in the promotion of international arbitration as a general dispute resolution mechanism. The statutory adjudication provisions introduced in the UK and others in the last 15 years or so, is another good example of beneficial government intervention to resolve a significant problem of imbalance within the industry. While the system is by no means perfect it has achieved significant benefits, and I shall return to adjudication later.

Governments are sometimes cautious in extending measures in support of contractors beyond the private sector and into their own **public sector contracts** as this could impact on their own payment and negotiating position vis-à-vis the construction industry. One should therefore consider government contribution to this debate under each of their two “hats”, firstly as the **legislative authority** which may be required to impose improvements to procurement and contracting systems to increase fairness or correct imbalances and, secondly as an **Employer** seeking to achieve best value for public works expenditure. The two positions are not always reconcilable.

The introduction of **mandatory adjudication** by the UK Government through the Housing Grants, Construction and Regeneration Act 1996 was a bold step and good example of a government wearing its legislative authority hat. As we heard from Neil

Kaplan, and vicariously Doug Jones and Robert Gaitskell, the Act itself (which is under revision at present) and importantly strong support from the English court system, has had a large and generally beneficial impact on the whole construction dispute resolution process in the UK and other jurisdictions which adopted a similar approach.

As with any putative “silver bullet” adoption of the concept alone does not guarantee success. As already mentioned, support from the courts has been important in setting the framework for **adjudication** to be effective and not overwhelmed by procedural and jurisdictional issues, specious appeals and other common attempts by dissatisfied parties and their advisors to throw sand into the smooth mechanisms of speedy dispute resolution. **It does, however, seem clear to me that the mandatory nature of the process was a dominant factor in its success. I commend this view to the SARG**, from personal memory of long discussions in the “Committee for discussion of Conditions of Contract” which old hands will remember as the principal forum for all such matters as we are considering today between the construction industry and the government in the eighties. Mediation was the hot topic at that time, and its introduction on a mandatory basis in contracts was much resisted on the grounds that this would “open the floodgates to spurious mediation requests by irresponsible contractors”. Twenty five years later we have yet to be overwhelmed.

This does, however, bring me to our own dispute resolution version of **Goodheart’s Law**. Prof. Charles Goodheart as an economic advisor to the Thatcher government in 1975 set out that any indicator or target which becomes a major determinant of policy rapidly loses the objective information content to enable it to do this. He was referring to money supply indicators, and a more recent and topical example might be the financial rating agencies such as Moody’s and Standard and Poors, whose ratings missed so many of the risks which engulfed the world financial system last year. The reason for this, and which also applies in issues that we are now considering, is referred to as “regulatory capture” in which the “gamekeepers “ gradually adopt the mindset of the “poachers” and thereby lose their objective ability to regulate effectively. Before this becomes too abstruse, let me explain what I mean in terms of the dispute resolution industry.

Dispute resolution outside the courts has a long and distinguished history, as Neil reminded us, but through time the speed and effectiveness of each procedure is blunted by the “**bolting on**” of procedures and rules with escape clauses and other complexities which add to the time and cost of the procedure. The classic example of

this is, of course arbitration, which in the construction industry has become as costly and lengthy as legislation and the two are often offered as alternatives with different benefits for comparison but no mention of cost or time efficiency. This is by no means caused solely by unscrupulous practitioners and parties exploiting flexibility to cause delay and substituting quantity for quality in submissions and statements of case.

The CI Arb among other bodies concerned with the future of dispute resolution are seeking to resolve this in the same manner as the English courts are attempting to reduce cost and complexity in cases. In final determination procedures this is by **case management** where the judge or arbitrator is encouraged to use their powers to compel the parties to be concise and efficient. I wholly support this principle.

As we have seen with adjudication in England, the enabling Act alone does not provide the necessary **procedural framework** to deal with all the various legal, procedural and other issues which arise in a minority of cases. These require a court decision to establish a precedent which becomes part of this framework. The journal of the CI Arb carries in each issue a summary of the cases in relation to implementation of the Act; I enjoy reading this principally to marvel at the range of issues which arise and the ingenuity of the parties presenting them.

I believe that we in Hong Kong are also seeing such **problems in mediation**, which in many cases, particularly in the public sector, is becoming cumbersome and long drawn out. There are a number of reasons for this, some of which are inherent in large construction contracts and some caused by the decision making process of the public sector.

The ideal concept of mediation in a construction contract is that any disputes are identified and negotiated away, with the help of the mediator, shortly after they arise during the contract. In practice this is not very realistic because of the **large number of potentially disputed issues** which seem to arise almost continually, and the **time taken** for these to crystallise and be determined as suitable for mediation. Many of such issues relate to disputed variations, both liability and value, which in turn interacts with the final measurement. In practice therefore I find most that I deal with become final account mediations covering numerous disputes under almost all the normal heads of claim (late or incorrect information, delay, unforeseen conditions etc.) as well as remeasurement and variation issues.

In terms of reaching settlement overall **final account mediations** have the major advantage that both sides are able to take a global financial view of the contract budget, commit their entire outstanding contingency, and justify the additional cost to higher authority and closure with no further financial or time commitment risk. Most disputes also have an optimum timing for settlement usually when the decision makers are reasonably aware of the issues and also the full consequences of prolonging the dispute much further; this moment can pass as the dispute moves more fully in to the hands of the lawyers dispute specialists who proceed to create a large and often artificial case that will be effective in arbitration or before a judge.

Although one does mediate **mid-contract dispute** issues, they are usually on major and often single issues, on a scale that could have adverse consequences for the successful continuation of the contract if unresolved, and this may provide encouragement for the parties to settle despite the absence of the incentive factors that I have just mentioned for the final account.

Turning to my second reason that speedy in-contract mediations seldom happen is that the current **SARG mediation preparation and approval process** is fairly slow and cumbersome, as indeed are these procedures in most public sector organisations. There is, of course, a political dimension to this reflecting the way in which the political authority or **legislature** checks and holds to account its public sector expenditure; if this is carried out in a heavy-handed manner it can seriously inhibit the good sense and professional decision making of the executive. As an example of this in HK, I offer the case of the mid-contract wrap-up deal with the electrical contractor Siemens on the KCR West Rail project where what most contract professionals would regard as an eminently sensible settlement received heavy adverse political attack.

What one might regard as a cumbersome process is therefore understandable in this context from the basic requirements of mediation which requires the parties' representative to be able to agree to a settlement "deal"; in practice therefore a **ceiling sum** has to be previously justified (in some detail) and approved prior to the mediation. This means that personal dynamics (which often contribute to disputes) and other unrevealed issues and factors that emerge during the mediation process (for the benefit of senior representatives seeking to take an objective view of their side's position) are effectively discounted in advance.

In terms of our topic of payment to contractors, mediation on this basis can be deemed **unsatisfactory**. The only improvement that I have been able to achieve is to suggest

that the early **appointment of a mediator**, whose normal function includes control of the process itself, gives a third party, the mediator, some power to manage the time and extent of information exchanges as part of the justification and approval exercise which unchecked can assume Jarndyce v Jarndyce proportions.

I now turn finally, and not before time you may say, to my views on **how the matter of prompt and fair payment to contractors may be achieved**. Identification of the problems is always easier than their solutions but I have also tried to explain why apparently good processes have not always had the desired effect. Goodheart's Law for construction is part of the reason as any new process or indeed law will attract clever and skilled practitioners to seek and exploit weaknesses and loopholes which then have to be closed so that further procedure is bolted on, and so on *ad infinitum*.

I nevertheless believe that **legislative action** is needed, e.g. the UK Act promoting adjudication, to overcome and discipline the political process which I mentioned above and which can seriously inhibit sensible and speedy commercial decision making at professional executive level. For this to work a protective legislative framework is needed to cover such decisions which undoubtedly can be achieved if thus supported.

I also firmly believe that a **firmer** approach is required in implementing such improvements. Adjudication if it is to become an effective solution needs to be made a **mandatory** step in the dispute resolution process in future government contracts. This increases focus and should reduce delay, as well as levelling the field, and resolves the public sector decision making issues that I have discussed.

Many, if not most, of the disputes that I see can be attributed to poor **contract preparation** in two main aspects. Firstly, the design and technical preparation is often poor, containing inconsistencies, lacking in detail and uncoordinated between disciplines. I do not attribute this to any poor quality of our construction design professionals who are highly competent and the equal of any, nor indeed is this problem unique to HK, as I see it in my mediations throughout the region. I blame the politically driven **low cost approach to procurement of design and contract management** services by Employers which results in design work reflecting the low fees paid for it. This is exacerbated in HK by the separate and relatively (only relatively) generous payment for site staff, providing incentive for designers to avoid further office design costs against low fees by passing all problems and conflict issues to the site team which is less equipped to handle it.

My second criticism of the preparation of many contracts is the **lack of overall consistency** within the various parts often prepared by different professionals e.g., the technical designs and drawings by engineers (often more than one) and architects, the contractual by lawyers, the valuation by quantity surveyors with a hearty dose of administrative input as well. I see many disputes caused by details differing between drawing, specification and payment schedule, or between contract conditions general specification and Bill preambles. There is an unfortunate tendency for the various contract preparers to bolt on clauses and concepts in the mistaken belief that these improve the contract.

I repeat my view that poor contracts well administered are more effective than good contracts badly administered and apply this also to dispute resolution mechanisms which need the application of good sense and flexibility to be effective. For this reasons I am attracted to the **Dispute Resolution Advisor (DRA) concept** which if, a big if, properly set up within the contract can provide early attention, good sense and objectivity and flexibility in dispute resolution method. I am less attracted to Dispute Resolution Boards (DRB), not because of any flaw in their principle, but because of their size and cost they are inherently more cumbersome and less likely to be properly used (my experience of the Taiwan HSR supports this). In passing I mention that I have used both DRAs and DRBs on contracts for which I have been the *de facto* Employer, but have not found the latter particularly helpful for the reasons I have given, and have also made little use of the DRA in practice because of, I believe, **proactive and sensible contract management by the project team** itself.

Adjudication also holds some attraction for me, with the usual proviso of effective implementation. In principle the concept is of speedy and, hopefully, cost effective dispute resolution traded against potentially rough justice with some advantage to the initiator and fast mover who gains preparation time. The **“rough justice”** concept can, of course be a red rag to politicians when they don their **public accountability** hats, ranking with “commercial deal or settlement” and “fluctuating price”. All these concepts properly applied may appear very sensible to contract professionals such as yourselves, but can inflame politicians seeking to ration calls on the public purse.

If adjudication is to be effective in HK, it needs to avoid the dangers which I mentioned as afflicting mediation, it does have the benefit of avoiding the problem of public sector approval for a negotiating ceiling that I discussed. There is still the need to enforce tight deadlines and reduce the voluntary or discretionary ability to delay or

add unnecessary detail as much as possible within the public accountability framework. Of course, if this could be done to mediation, it too would become more speedy and effective. As I mentioned above, a good first step in the speedy and effective implementation of adjudication would be to make it a mandatory step in the dispute resolution process in government contracts.

HK is sensibly cautious and relatively slow to introduce radical changes to the contracting regime of its construction industry. We have tended to dabble with the more relationship based approaches to contracts rather than embrace them, and in that respect seem to have **fallen behind** many similar jurisdictions. However, as I hope I have made clear above all else, I am convinced that there is **no silver bullet** and that effectiveness lies in the **quality of the implementation** rather than the actual process or procedure.

I commend the Civil Engineering Committee of the HKCA for arranging this conference on topics which are both timely and relevant, and I thank you all for listening to my views.