

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

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**Goodbye to the Gentleman's Agreement,
Hello to Statutory Adjudication**

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Introduction

It took a respectable English judge who happened to be trained in mathematics to give true meaning to his understanding of what is meant by the need for contractors and subcontractors to have the necessary cash flow so that enterprises are not starved of this lifeblood. Lord Denning had said in the case of *Dawnay*¹,

“There must be a “cash flow” in the building trade. It is the very lifeblood of the enterprise. The sub-contractor has to spend money on steel, work and labour. He is out of pocket. He probably has an overdraft at the bank. He cannot go on unless he is paid for what he does as he does it. The main contractor is in a like position He has to pay his men and buy his materials. He has to pay the subcontractor. He has to have cash from the employers, otherwise he will not be able to carry on.”

The bold attempt at creating judge-made law was short-lived. The idea of an Architect's certificate taking the status of a bill of exchange guaranteeing payment without the right of set-off, was rejected by the House of Lords with Lord Diplock leading the attack in *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1973] ALL ER 195.

A quarter of a century later, the soul of Lord Denning must be smiling at the enactment of the Housing Grant and Construction Regeneration Act (HGCRA) 1996 which was passed by the UK Parliament pursuant to Sir Michael Latham's report “Constructing the Team” of 1994. Whilst the status of the architect's certificate did not become as good as cash, the cash is made to flow by the process known as adjudication.

Indeed, the family of legislation to ensure cash flow grew when Australia and New Zealand adopted the idea of adjudication. In Australia as in Singapore, the legislation has its existence under a rather misleading part name of “Security of Payment”. The respective Acts do not secure payment as much as it does facilitate payment.

However, it is interesting to note that New Zealand might have gone the way of US and Canada had its Wages Protection and Contractors' Liens Act 1939 developed in the direction of the two American countries. As it stands now, the 1939 Act had been repealed and the Construction Contracts Act, which adopted the adjudication approach, was enacted in 2002.

In the US and Canada, the cash flow is ensured by way of the Mechanic's Lien and payment bonds and had started to evolve as early as the late 1700s. Currently in the US,

¹ *Dawnay Ltd v FG Minter* [1971] 2 All ER 1349.

there are Prompt Payment Acts in certain states which provide for timely payments subjected to the pain of attracting a very high interest for late payment.

Problems faced in securing progress payment

A gentleman's agreement with their respective honour as their word would certainly ensure that there would be cashflow for work properly done. Alas, the world suffers from a shortage of this kind of gentlemen or perhaps the modern gentlemen has no means of checking whether work is properly done. Be that as it may, the building industry has been left with many standard forms of building contracts and legislation that have re-written the concept of freedom of contract. Whilst there are champions of this concept, there are also reservations as represented by the views of Roscoe Pound in his "Liberty of Contract" (1909), where he critiqued the concept of freedom of contract.

The standard form of building contract might be said to have laid a very firm foundation to assist in preventing the cash from flowing. Three features are common:

First, the entitlement to payment in the main contract is usually dependent on the Certificate of Payment being issued while in the subcontract, it is common to have the pay-when-paid provision. The permutation of situations of non-payment, under payment or late payment in a main contract might be attributable to: (a) failure to certify payment; (b) late certification; or (b) under-certification. In the case of the subcontract, the main excuse would be that the main contractor himself is not paid regardless of whether the non-payment was attributable to the subcontract concerned.

The second point concerns the right to set-off provided by the contract. However, the party making payment may also rely on the right to set off given by the common law and equity. This is a necessary evil against guaranteed cashflow as payment should not be made if work is not properly done. In addition, there might be defects which require repair and late completion. On this point, the attempt by Lord Denning mentioned in above to bring about a change by way of the common law was brought to an almost immediate halt by the House of Lords in 1973.

A more successful attempt by way of contract was made by the late Duncan Ian Wallace when he drafted the Singapore institute of Architects (SIA) Articles and Conditions of Building Contract in 1979, presumably to address the development in case law at that time. The late Wallace drafted into the standard form, the provision that the content of an architect's certificate would not be challenged by both parties and thereby, allowing the contractor to obtain summary judgment subject to only contractual set-offs that are prescribed by the contract. Thus, contractors have been obtaining summary judgments based on amounts certified by the aArchitect.

“Clause 31.(11)...in the absence of fraud or improper pressure or interference by either party, full effect by way of Summary Judgment or Interim Award or otherwise shall, in the absence of express provision, be given to all decisions and certificates of the Architect (other than a Cost of Termination Certificate or a

Termination Delay Certificate under clause 32(8) of these Conditions), whether for payment or otherwise, until final judgment or award, as the case may be, and until such final judgment or award such decision or certificates shall (save as aforesaid and subject to sub-clause (4) of this condition) be binding on the Employer and the Contractor in relation to any matter which, under the terms of the Contract, the Architect has a fact taken into account or allowed or disallowed, or any disputed matter upon which under the terms of the Contract he has as a fact ruled, in his certificates or otherwise.

Thus, the learned judge, Warren LH Khoo J, held in *Aoki Corp v Lippoland (Singapore) Pte Ltd* [1995] 2 SLR 609; [1995] SGHC 50 that,

“31 Clause 31.11 of the SIA conditions of contract provide, so far as relevant for present purposes, that no certificate of the architect shall be final and binding, but in the absence of fraud or improper pressure or interference by either party, full effect shall be given to all certificates of the architect, whether for payment or otherwise, until final judgment or award.

32 It is provided by cl 37.3 that the arbitrator to whom any dispute is referred is not bound by any certificate, refusal of certificate, ruling or decision of the architect, but may disregard it and substitute his own decision on the basis of the evidence before and facts found by him. Clause 37.3 also provides that where the architect has not made a ruling or decision or has not given a certificate, the arbitrator has the power to deal with the matter.

33 The object of these provisions of the contract is that certificates issued in the ordinary course by the architect are to be honoured, and that any challenge in relation to them should be referred for arbitration, although, as can be seen in the *Tropicon*² case, where the circumstances are such that the legality or propriety of a certificate can be decided by reference to the terms of the contract and the circumstances in which it was issued, the court will not hesitate to deal with the matter even in summary judgement proceedings.”

The third feature concerns the resolution of the impasse created between a claim based on a certificate of payment faced with a right of set-off. As in all disputes appearing in standard forms of building contract, such disputes must be referred to arbitration and in the older forms, arbitration cannot be commenced until after completion of the works with some allowing an exception if the Employer consents.

In summary, except for contractors using the SIA form of building contract, most contractors and subcontractors would succumb to one or a combination of the three features found in the contracts and therefore continue to soldier on without the necessary cashflow and some have been known to become insolvent as a direct result of this deprivation of the lifeblood.

² *Tropicon Contractors Pte Ltd v Lojan Properties Pte Ltd* [1989] SLR 610

Ensuring cashflow

Using the Singapore Building and Construction Industry Security of Payment Act 2004³ (“SOP Act”) as reference, an examination of the legislation would show that it addresses the three features by providing answers to them.

Thus, the first feature found in the SOP Act that address the issue of contractual entitlement to payment is the statutory payment scheme. By having a stand alone payment scheme that does not depend on the building contract, the contractor or subcontractor need only look towards the Act to establish his right to payment. This is because, section 5 of the Act provides that the entitlement to payment is dependent on work being carried out and not on certification. This amount is referred to as progress payment.

Section 6 and 7 provides the formula for working out the progress payment amount. While section 6 allows the parties to agree to a formula, the failure to do so would only mean that the default formula as set out in section 7 would become applicable. The formula contains familiar items like work done, materials that are on site, and deduction for defects. Section 8 prescribe a formula for calculating the due date for the payment of the progress payment amount. Like section 6 parties may agree to the formula but to ensure that there is not delay, section 8 prescribes the maximum time period for fixing the said due date. And this prescribed due date would be applicable if parties agree to a later due date

The second feature is what could be referred to as a statutory adjudication scheme. It has two parts separated by a statutorily prescribed attempt to settle dispute called the dispute settlement period. This is unique to the Singapore Act not found in the New South Wales Act.

The first part effectively replicates a “letter of demand” process. A Payment Claim is issued should there be a failure to make payment of the amount of progress payment on the due date set out in section 8. The Payment Claim sets out the Claimed Amount. This Claimed Amount is defined by section 2 to have two parts, that is, the unpaid amount of the progress payment and interest that would run from the due date to the date of the payment claim. The person making the Payment Claim is the Claimant and the person asked to pay is the Respondent.

The Respondent is given a chance to reply in a Payment Response which is an important document that, *inter alia*, sets out the reasons for withholding payment. Should the Respondent fail to put in the Payment Response, he would be barred from raising such reasons at the adjudication stage. The Respondent may offer to pay a smaller amount than the Claimed Amount and if accepted the dispute ends there. If not, then it is likely that the dispute proceeds to the next stage which is the dispute settlement period. Thus, it is noted that while a Respondent is not deprived of his right to set-off, he would loose it if

³ Please note that the Singapore Act bears the same name as the one in New South Wales.

he fails to put in a Payment Response. The justification for this loss of right comes in the form of a second chance because the Adjudication determination has only a temporary binding effect until the dispute is resolved by the contractually agreed method of dispute resolution.

At the dispute settlement period, parties could bring the procedure to an end if they are able to settle the dispute. If not, the Claimant is entitled to put in an Adjudication Application to commence the adjudication. The Singapore Mediation Centre is the authorised nominating body under the Act. It receives the application, nominates a person to act as an adjudicator. At the same time, the Centre would serve the Respondent with a copy of the adjudication Application. The Respondent is entitled to serve an adjudication Response. The Adjudication then commences upon the expiry of the period given to the Respondent to serve the Adjudication Response.

Unlike arbitration which most standard forms provide, statutory adjudication is much and faster much cheaper. The prescribed time lines are 7 days for application without Payment Response and 14 days where the adjudicator has to consider the Payment Response as well as the Payment Claim. The fees payable to the authorised nominating body and the adjudicator are fixed and are set out below:

“Costs of adjudication proceedings

Regulation 12. For the purposes of section 30 (1) of the Act —

(a) the fee payable to an authorised nominating body shall not exceed —

- (i) \$500 for each adjudication application; and
- (ii) \$1,000 for each adjudication review application; and

(b) the fee payable to an adjudicator (including a review adjudicator or a panel of review adjudicators) shall be computed on the basis of a rate not exceeding \$2,000 per day or \$250 per hour, subject to —

- (i) where the claimed amount exceeds \$20,000, a maximum of 10% of the claimed amount; or
- (ii) in any other case, a maximum of \$2,000.”

The third feature that facilitates payment is the statutory enforcement scheme found in Part V. Where the Respondent fails to pay the whole or part of the adjudicated amount, (a) the Claimant is entitled to a lien on goods supplied by the Claimant to the Respondent under the contract concerned that are unfixated and which have not been paid for; (b) suspend carrying out construction work; (c) apply for and enforce the adjudication determination as if it were a judgment debt. In addition, the Employer, in a claim by a subcontractor against the main contractor, could make direct payment to the subcontractor under the prescribed conditions.

The Singapore Experience

The Singapore experience appears to follow the experiences of the other countries which have adopted the adjudication approach, ie, a slow start and an increase in the cases. It is also likely to lower the number of arbitrations although it is too early to tell at the moment.

Whilst the Claimants appear to be well advised, the Respondents appear to be unaware of the Act. This is based on observations of the numerous cases⁴ where the Payment Response is not served and where it is served or purportedly served, it is ineffective as it does not properly set out the reasons to withhold payment.

Observation

As in the other jurisdictions, contractors and subcontractors as well as consultants are learning to use the three statutory schemes in the SOP Act. The number of cases has increased year-on-year. The faster and cheaper route to payment should see a financially healthier building industry. The publication of the Adjudication Determinations is certainly good as a learning platform for all.

As the most regular user is likely to be a subcontractor and consequently, he is likely to be not familiar with the English text of the SOP Act being fluent in Mandarin and not English, the Building and Construction Authority of Singapore, the authority overseeing the Act, should strive to introduce an official document in the Chinese language that translate the SOP Act. This situation would not occur in Hong Kong.

Concluding Remarks

Cash flow is certainly the lifeblood of an enterprise and the SOP type of legislation goes a long way to ensure that there are no unnecessary cases of bankruptcies and winding up of contractors and subcontractors. The SOP Act intervenes somewhat like the consumer protection legislation that protect the weaker contractual party in consumer contracts. This must necessarily compromise the concept of freedom of contract even at the expense of dispensing with the need for certification of payment.

The Act ensures that no contractor or subcontractor should be prevented from pursuing his right to payment by ensuring that statutory adjudication is fast and cheap. In addition, the Act ensures that the Adjudication Determination is effective by providing a statutory enforcement scheme.

At the same time, the right to set-off is preserved. Given the fast paced environment that statutory adjudication operates in, it might be said to bring about “rough justice”. However, parties are not prevented from pursuing their contractual dispute resolution methods as the adjudication determination has only temporary finality status.

⁴ See Statutory Sdjudication in Singapore by Dr Philip Chan, Sweet and Maxwell, 2008 and Singapore Construction Adjudication Review by Sweet and Maxwell, 2009.