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Managing risk - what changes are afoot?

The last year has been an interesting one for those involved in UK PFI/PPP projects.

For project companies (and to an extent their sub-contractors) the issue of ensuring that the risk of claims and non-performance is appropriately passed up, down and across the contractual chain was brought sharply into focus by:

1. A decision of the Scottish Courts - *Kent County Council -v- Robertson Construction Northern Limited* - regarding the application and pass through of performance deductions under an interface agreement; and

2. The government's changes to the Construction Act which will (when they come into force) limit the tools available to the project company for managing the risk of sub-contractor's claims. The changes herald the death of what are known as "equivalent project relief" provisions. In simple terms such provisions make the sub-contractor's entitlement to additional monies dependent upon the project company's entitlement under the project agreement.

Both merit close scrutiny as they have serious implications for how parties deal with non-performance and manage their risk.

Pass through of Performance Deductions

Liability for performance deductions can raise difficult questions in the operational stages of a project as to which sub-contractor is responsible for the failure in question – ie the building or FM sub-contractor. Although, so far as the authority is concerned the project company takes responsibility for both, there will be two or three sub-contractors to whom the project company will seek to pass through deductions from the authority.

To limit the project company's risk of (a) the "buck stopping with them" and (b) becoming embroiled in disputes as to which of the sub-contractors is ultimately liable, an interface agreement is often entered into amongst the project company and the building and FM sub-contractors.

The aim of such an agreement is simple:

- to make sure the project company can pass on its liability for deductions regardless of which of the sub-contractors failed; and

- to apportion responsibility for the deductions amongst the sub-contractors.

Without such an agreement, the sub-contractors would have no contractual relationship between themselves.

The Kent case shows the problems that can arise from such interface agreements and generally from the fact that construction and operational obligations are owed separately by the building and FM sub-contractors.

The case arose from a schools' PFI project. The construction works had been completed but certain furniture, to be supplied by the building contractor and in turn the project company, was outstanding. It had been noted as a snagging item.

Following service commencement, the authority levied deductions against the project company as they contended a breach of a performance standard which required the project company (and in turn the FM contractor) to "maintain all Loose Furniture and Equipment operational … and to replace and/or upgrade in accordance with … the Authority's Requirements".

The project company passed the deductions through to the FM sub-contractor who in turn passed them through to the building sub-contractor under the interface agreement. The case came to court because the supplier of the furniture (the sub-sub contractor) took issue with the building sub-contractor passing through the deductions to it.

The building contractor said that under the interface agreement it didn't need to prove breach of the performance standard. Rather it only needed to show it had suffered the deduction. The court did not accept this.

It found that a proper link between the performance standard, the deduction and the sub-sub contractor's breach had to be established. Here no such link was established. There was a break in the "pass through" chain.

This was because the court found the performance standard in question was a maintenance obligation which could not impose an obligation to supply or maintain furniture which was not there in the first place. The snagging obligation, which existed relative to the furniture, was a separate and distinct obligation from the performance standard.

This decision turned on the particular wording of the performance standard in question. Although the dispute occurred at sub-contract level, it shows that careful consideration should be given to drafting across the board – of project agreements, sub-contracts, and interface agreements – if the intention is that failures of the building contractor are to lead to performance failures, a corresponding right to deductions and ability to pass those deductions through as appropriate.

Claims from Sub-contractor level up

The Kent case concerned the situation where claims arose from the top down. What about the reverse situation where claims come from sub-contractor level up?

The party most at risk here is the project company. As the "middle man", it wants to make sure (a) that any entitlement of the sub-contractor mirrors its entitlement from the Authority; and (b) that in terms of timing of payments, the obligation to pay the sub-contractors does not arise until the project company is in receipt of funds from the authority - a cash-flow issue.

A number of tools have been developed to manage this risk:

Equivalent Project Relief Provisions

Basically these prevent the sub-contractors from pursuing a claim against the project company until such time as the project company has resolved its entitlement up the line with the authority. They are often accompanied by name borrowing provisions which, in certain circumstances, allow the sub-contractor to borrow the project company's name and thereby effectively pursue the claim directly against the authority. This gives the sub-contractor control over pursuing their entitlement and allows the project company to pass the cost and time aspects of the claim to the sub-contractor.

These provisions are effectively a form of "pay when certified" clause – ie where payment under one contract is dependent on what is found due under another.

Parallel Loan Agreements

To allow for the situation where the project company is found liable to pay a subcontractor BEFORE it has recouped "up the line", parallel loan agreements have been devised. This is where the sub-contractor (or their parent company) agrees to loan the project company the equivalent sum of any award made in its favour pending resolution of matters with the authority. The idea being that the project company is not left out of pocket in the meantime.

Joinder

Another fall back to EPR is ensuring the sub-contractor's claim is never dealt with in advance of the project company's claim. As sub-contractors can use fast track dispute resolution provisions such as adjudication, joinder provisions allow adjudications at project agreement and sub-contract level to be brought together and dealt with by the same adjudicator. The result is that decisions under the two contracts should be issued almost simultaneously.

Construction Act

The problem with EPR is its inter-relationship with the application of the Construction Act to PFI projects. The Act does not apply to Project Agreements but it does apply to the sub-contracts - construction and hard FM.

There has been much debate in the past over whether equivalent relief provisions fall foul of the Construction Act. In the past, the debate has focused on whether or not such provisions fall foul of the sub-contractor's right to adjudicate a dispute at any time. That right comes from the Construction Act and cannot be taken away by contract. The decision of Justice Jackson in the case of *Midland Expressway Limited and CAMBBA* confirmed that such provisions could not override the right to adjudicate.

There was also a school of thought that equivalent project relief provisions were more than "pay when certified" provisions – in fact they were "pay when paid" provisions which is again prohibited by the Construction Act (except in certain limited circumstances).

The new amendments to the Construction Act will put the unenforceability of the equivalent project relief provisions beyond doubt. Not because of the right to adjudicate but rather because the amendments will outlaw "pay when certified" provisions. There are also questions about the enforceability of parallel loan agreements and whether in practice, given issues over timing of enforcing parties' rights, they in fact provide a solution.

When do the amendments come into force?

There is no set timescale but it is likely to take at least 12-18 months. It is worth noting that the amendments will not have retrospective affect. So for projects which sign before the amendments come into force, the position is very likely to be that, if challenged, equivalent project relief provisions will be unenforceable but parties may for commercial reasons (particularly where the sub-contractor owns an interest in the project company) choose to operate them.

So what does this mean for project companies involved in projects which close after the amendments come into force? How can they protect their interests and manage the risk of sub-contractor claims?

Basically, the safest option is the proper use of the joinder provisions. Although these provisions appear complicated, they arguably provide the most effective answer to the demise of equivalent project relief. They simply require the project company to make sure they understand and follow the terms of their contracts. Of course if parties are in agreement they may still choose to include and operate EPR provisions in their contracts anyway.

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