HFW

CONSTRUCTION BULLETIN
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Welcome to the March 2023 edition of our Construction Bulletin.

In this edition we cover a broad range of recent developments in international construction law, as follows:

- Steps taken by the Hong Kong administration towards the introduction of statutory adjudication in the Special Administrative Region;
- Managing interface risk in the delivery of lump-sum EPC turnkey agreements for energy and infrastructure projects;
- The English High Court's clarification of the test to be applied in a "Battle of the Forms" scenario; and
- An example of an occasion where a contractor lost its right to terminate its construction contract as a consequence of a delay in exercising that right.

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"The CISP Bill envisages that a statutory adjudication regime will apply to all construction contracts, whether they specify adjudication and whether they are public works contracts or other construction contracts in the public or private sectors."

SECURITY OF PAYMENT IN HONG KONG

Hong Kong took another step towards implementing a statutory adjudication regime for payment claims under construction contracts when the Construction Industry Security of Payment Bill (CISP Bill) was listed as a piece of legislation that will be introduced to the Legislative Council (LegCo) during 2023. The introduction of a bill to LegCo is one of the last stages prior to the bill being passed into law.

Background

A statutory adjudication regime for payment claims in Hong Kong has seemed possible since at least 2011, when the HKSAR Government carried out a survey which confirmed that cashflow, payment disputes, extension of time issues and unfair contract terms were adversely affecting many stakeholders in the construction industry. A consultation study was carried out in 2016 with similar results.[1] However, it is only with the recent developments in the last 18 months that the prospects of statutory adjudication has appeared to gain momentum.

Recent developments

In October 2021, the Development Bureau issued a Technical Circular[2] mandating that certain public works contracts entered into on or before 31 December 2021 incorporate prescribed security of payment provisions. The Technical Circular also provided that all other public works contracts would need to follow suit from 1 April 2022. The prescribed provisions included:

- a prohibition on conditional payment provisions (also known as "pay when paid" provisions);
- prescribed maximum periods for determining payment claims;
- a right to refer payment disputes to adjudication within 28 days from the date when the payment dispute arose;
- a right to suspend or reduce rate of progress if adjudicated amounts are not paid; and
- a right for the Employer to directly pay subcontractors unpaid adjudicated amounts.

While the Technical Circular was a significant step for security of payment in Hong Kong, the prescribed contractual adjudication provisions were only required for public works contracts and there is no requirement for them to be included in other construction contracts, including in the private sector. Moreover, the regime only applied when it was included in the contract. This is different from a statutory adjudication regime, which applies regardless of the contractual dispute resolution mechanism.

In April 2022, the first draft of the CISP Bill was completed for consultation. The CISP Bill envisages that a statutory adjudication regime will apply to all construction contracts, whether they specify adjudication and whether they are public works contracts or other construction contracts including in private sectors.

What to expect

When LegCo published its 2023 Legislative Programme earlier this year, the CISP Bill was named as legislation planned to be introduced to LegCo during 2023. Until then, the position remains that adjudication is only available to those whose contracts specify it. If a statutory adjudication regime is enacted in Hong Kong, it would bring it into line with other common law jurisdictions including the UK, Singapore and Australia. If the experience in other jurisdictions is anything to go by, it will play an important part in protecting the cash flow in the local construction industry.

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1 Development Bureau, *Report on Public Consultation on Proposed Security of Payment Legislation for the Construction Industry* (2016).

2 Development Bureau Technical Circular (Works) No. 6/2021.

BATTLE OF THE FORMS

Concluding a deal of any kind will typically involve an exchange of documents. This could include requests for tender or quotation, tender responses or quotations, purchase orders, contract forms, specifications and invoices. It is not unusual for each exchange to contain terms and conditions which are intended to apply and generally those terms will be self-serving. As a consequence of the parties adopting self-serving positions there are often conflicting terms and, where things have gone awry in the delivery of goods or services, a dispute as to what constitutes the contract can arise.

While in some cases (and in most, but not necessarily all, large deals) there is a formal contract formation process, an entire agreement provision and clear contract execution, in many cases particularly further down the supply chain this does not occur. What is the test to apply in those cases?

The Last Shot and when is it fired?

The case of *Butler Machine Tool Co Ltd v Ex Cell O Corp (England) Ltd*[1] was a case where there had been an exchange of documents and no formal contract formation process. Lord Denning MR held:

... The better way is to look at all the documents passing between the parties and glean from them, or from the conduct of the parties, whether they have reached agreement on all material points ... applying this guide, it will be found that in most cases when there is a "battle of the forms" there is a contract as soon as the last of the forms is sent and received without objection being taken to it... .

This case is over 40 years old and the approach suggested by Lord Denning has been routinely adopted by courts in the UK and Australia. It is typically referred to as the 'last shot rule'.

The position has been clarified by the very recent English High Court decision in *TRW Ltd v Panasonic Industry Europe GmbH*[2] where it was made clear that the determining 'shot' is the one that is unequivocally accepted by the other party. In that case TRW signed a Panasonic customer form stating that:

... the following terms and conditions shall apply exclusively to the entire business relation with us ... unless different conditions, particularly conditions of purchase of the contracting party, have expressly been confirmed by us in writing.

The fact that TRW later issued purchase orders containing alternative terms did not override the agreement formed when TRW had signed the customer form as Panasonic had not expressly confirmed acceptance of TRW's alternate terms.

Courts in common law jurisdictions, including the Australian and Singaporean courts, have generally adopted the English law approach when asked to determine when a final and unqualified acceptance has occurred.

Take Away

Procurement teams need to be conscious of what they are agreeing to. A buyer of goods or services doesn't buy goods on its own terms simply because it attached its terms to its request for quotation. Similarly, a seller doesn't sell its goods and services on its own terms simply because it attached its terms to its quotation.

Care needs to be taken at the time of closing and, if things go wrong, in negotiations, to ensure that your terms apply to the deal or an agreed position is reached.

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1 [1979] 1 WLR 401.
2 [2021] EWHC 19.

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"Proper management and mitigation of interface risks can be a significant factor on the profitability of any major energy or infrastructure project."

INTERFACES: ADDRESSING THE RISKS IN YOUR PROJECT

A key category of risk associated with the delivery of lump-sum EPC turnkey agreements for energy and infrastructure projects is interface risk. Broadly speaking, this is the risk that arises from the interconnection and relation of the inputs that various parties contribute to the project.

There are many categories of interface risk that can arise on any project. Three of the most common are:

1. Interface with the site;
2. Design interface; and
3. Work package interface.

It is easy for Project Owners to simply transfer all risk to the Contractor – and in many cases this is what occurs. However, this has consequences. Inevitably, contractors will price risk, but also the pool of contractors willing to undertake the work may be diminished, reducing choice and competition (which can also further inflate price).

Equally, where a non-balanced approach is taken by the Project Owner or Contractors inadequately price these risks, the project is likely to become claims driven as the Contractor seeks to recover its financial position and likely escalate into dispute resolution – which is costly for both sides. Ultimately, the project may become distressed, and a Contractor become at risk of insolvency, leaving the Project Owner to hire a new Contractor to finish the project – who are unlikely to take any design, time or other existing risks through the takeover.

Identifying Risks

Developing strategies to deal with risks should be done at an early stage of the project by both Project Owner and Contractors. Identifying relevant interface risks should be one of the first steps and should guide the approach to contracting and delivery. Ideally, the tender process should be optimised, and the Contractor should use the opportunity for open discussions with both the Project Owner and other interfacing parties prior to the finalisation of contracts.

Striking a balance in the contract is key. An old adage but, as a general principle, risks should be borne by the party best placed to manage them.

Interface with the site

Site conditions are typically defined as the physical conditions on or around the site. It is often the case that the existing site results in requirements or limitations on the works. In many standard form contracts the Contractor will be entitled to time and cost for unforeseen site conditions, see for example clause 4.12 of the FIDIC Yellow Book. However, we often see these provisions amended to place a higher standard of risk on the Contractor in relation to the site and environmental conditions.

An example clause that has been amended to be unfavourable to the contractor is below:

a) The Contractor bears the entire risk of any and all physical conditions at the Site.

b) The Contractor represents and warrants the Project Owner that it has:

   i. fully investigated the Site and its surrounds;

   ii. has verified all information provided by the Project Owner in connection with the Site; and

   iii. cannot rely on the accuracy or completeness of information provided by the Project Owner in connection with the conditions of the Site.

c) The Contractor has No Claim against the Project Owner in connection with the physical conditions of the Site and any loss or damage that arises due to a failure of the Contractor to comply with its obligations under subclause (b) above.

The general intent of clauses like the above is to limit the qualifications the Contractor is entitled to make regarding the site and reduce the extent to which, or even prevent, the Contractor from relying on information provided during the tender phase.

Greater requirements for investigation and verification will ultimately restrict the contractor's ability to prove that it could not have reasonably foreseen an adverse site condition.

The Contractor should negotiate towards a site condition position where it can rely on documents which it cannot independently verify and, if the Project Owner rejects a broad exclusion for unforeseen conditions, specific exclusions should be identified and carved out of the Contractor's responsibility. An appropriate carve out should also be considered for defects in existing structures, early works by others or historical works.

The above mitigation does not account for utility and service connection requirements that may be relevant to the project. Specific interface agreements with relevant utility providers or other stakeholders should be contemplated where a framework for review and approval of designs, inspections, approvals and oversight may be required or is beneficial for the parties.

Design Interface

In a lump-sum EPC turnkey agreement, the Contractor bears the responsibility of finalising the design to the point of construction. This involves the careful coordination and integration of various design elements that are necessary for the project. This can be practically managed through Building Information Modelling (BIM) or similar technology. Nevertheless, errors can still arise despite the use of technical tools to coordinate the architectural and engineering inputs from various parties. Most often these errors from the integration of design elements are only discovered when works commence and the deficiencies are presented before the eyes of the Contractor.

Because the discovery of design integration defects most commonly come during the construction phase they frequently come at a high cost to the Contractor, especially if slippage in the program occurs due to the need to re-construct completed portions or re-design yet to be constructed works.

An explicit requirement in relation to design integration can be included as a mitigation technique by Project Owners or Contractors. In a downstream subcontract this can take the form of a clause similar to the below:

In completing the Subcontractor Designed Works, the Subcontractor must ensure that the Subcontractor Designed Works are designed in such a way as to:

a) integrate with the balance of Subcontract Works, the Main Contractors Works and the works of separate contractors; and

b) minimise the requirement for changes to the design of the Main Contractors Works and the works of separate contractors.

This type of clause specifically calls out the design integration obligations and limits the argument that could be made that the design, while incapable of correctly integrating with the design of other stakeholders, meets the project requirements or other design objectives and therefore is not inconsistent with that party's design obligations.

Work Package Interface

Physical interface between stakeholders who must connect or interact to enable completion of the works is perhaps the most obvious example of an interface risk. While being related to the design risk already described above, in this case poor quality workmanship and failure to build in accordance with the design must also be considered.

While this category of risk often arises intra-contract between the Contractor and its subcontractor, it is also common for these problems to arise between various subcontractors with no contractual relationship. To help secure a Contractor's position against this issue, a clause such as the below can be included in downstream subcontracts:

The Subcontractor:

a) warrants that it will examine, inspect and investigate all work and finishes of any separate contractor, subcontractor or other third party which is on, adjacent to, or in the vicinity of any part of the Site on which any part of the Subcontract Works are to be performed, with which the Subcontract Works are to be integrated, or which may otherwise impact on the performance of the Subcontract Works; and

b) must ensure that prior to commencing work on any part of the Site, the work and finishes referred to in paragraph (a) are adequate, appropriate, and sufficiently complete to enable the Subcontractor to carry out the Subcontract Works in accordance with its obligations under the Subcontract and the Stated Purpose.

This clause broadens the responsibility of subcontractors in relation to integrated works and serves two primary functions. Firstly, it ensures that subcontractors verify the works of others and assists the Contractor in overseeing the project. Secondly, a subcontractor who does not undertake reasonable verification of the works with related works is likely to have limited recourse upstream. This two-pronged approach is particularly effective because it assists the Contractor in identifying integration faults at the earliest possible stage and limits exposure of the Contractor to subsequent claims.

Conclusion

Proper management and mitigation of interface risks can be a significant factor on the profitability of any major energy or infrastructure project. Serious consideration by both Project Owners and Contractor should be given to the interface risks and appropriate technical, commercial or legal measures should be taken. The result of improperly managing or mitigating this category risk are million, or even billion, dollar claims.

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"Termination is generally the last option and parties should not terminate without carefully considering all eventualities."

TERMINATION: "DELAY BREEDS DANGER" HOW NOT TO LOSE TERMINATION RIGHTS

Terminating contracts has profound commercial consequences. Therefore, contracts usually contain elaborate provisions governing the applicable procedure to exercise termination rights. All this means termination arguments are usually difficult and acrimonious.

In this context, the recent English court decision[1] is worth reading. The court decided that the contractor lost its termination right by delaying in exercising it.

The decision

Parties to two shipbuilding contracts fell out and both sought to terminate the contracts.

One of the employer's arguments was that the contractor waived any right it had to terminate by:

1. Delaying in exercising it; and/ or,
2. Agreeing further amendments to the contracts.

The employer's point was this: when a termination right arises, the innocent party must decide either to terminate or affirm the contract, despite the breach. It cannot get all the benefit of the contract and still terminate later. It may reserve its rights for a while but not indefinitely, nor can it act inconsistently with the reservation. The court ultimately agreed.

So how long is too long? The court said this depends on the facts of the case, although clear evidence of affirmation is needed, and an excessively technical approach is undesirable. Relevant factors include whether: (a) there is any urgency; or (b) the defaulting party will be prejudiced by a delay.

Here, the contractor knew enough to decide whether to terminate for months, during which time it participated in discussions aimed at continuing the contracts. Meantime, the employer spent money assuming the contracts continued and missed opportunities to engage an alternative contractor. The fact the contractor did negligible substantive work was irrelevant. In the circumstances, belated termination was impermissible because it led to unreasonable "flux and uncertainty". The court found the contractor was wrong to terminate and was itself liable for damages.

Learning points

Termination is generally the last option and parties should not terminate without carefully considering all eventualities. On the other hand, it is now clear that delaying too long could prejudice their termination right.

How can this tension be resolved? Here are some non-exhaustive suggestions that may be useful depending on the circumstances:

1. Engage lawyers – Termination is a legal/contractual process which can get complicated quickly
2. Read the contract – Is there a right to terminate? Follow the termination procedure precisely.
3. Gather the facts and forward plan – What project events are forthcoming and when?
4. Consider the other party – Prejudice to the defaulting party is relevant. Are significant payments due soon? Do they need to engage with interfacing contractors? Do they have upstream commitments?
5. Put your position clearly in writing to the other side. Continue to write as the situation evolves.
6. Time limits – Usually, putting a time limit on the other side's cure period or resolution discussions is helpful. Make it a reasonable one and decide in advance what you will do when that period expires.
7. Hold points – If the position changes, review before acting. Does accepting part payment of an outstanding sum undercut a termination right?

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1 *Havila Kystruten AS v Abarca Companhia De Seguros, SA [2022] EWHC 3196 (Comm) (16 December 2022)*

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