CITY OF LONDON LAW SOCIETY

CONSTRUCTION COMMITTEE

GUIDANCE ON PFI SUB-CONTRACTS FOLLOWING

MIDLAND EXPRESSWAY - V - CARILLION

The Construction Committee of the City of London Law Society has published this Guidance for those engaged in advising on the first tier construction and facilities management sub-contracts of PFI projects in connection with their interaction with Section 113(1) of the Housing Grants Regeneration & Construction Act 1966 (*HGCRA*) and in light of the judgment of Mr. Justice Jackson in the case of *Midland Expressway vs. Carillion Construction Limited & Others* [November 2005] 2963 (TCC).

The Guidance is composed of the following Sections:

1. Recommendation to Extend the Exclusion Order;

2. Best Practice Recommendations for PFI sub-contracts;

3. Alternative Approaches;

A Background Paper is also attached to this Guidance. This reviews the rationale for different payment entitlement provisions applying to PFI sub-contracts and a summary of the potential conflicts with this rationale set up by s.113 (1) HGCRA and the *Midland Expressway* case.

Construction Committee, City of London Law Society
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1. RECOMMENDATION TO EXTEND THE EXCLUSION ORDER

1.1 The Construction Committee has considered various contractual devices intended to reconcile the clash summarised in the Background Paper between the practice and policy of PFI projects and the potential application of s.113(1) HGCRA, including in light of the comments made in the *Midland Expressway* case.

The 'best practice' recommendations of the Committee for these purposes are set out in Section 2 below whilst Section 3 reviews alternative approaches. Both Sections assume that the parties to a PFI sub-contract have agreed to seek to avoid the difficulties presented by s.113 (1) of HGCRA (and arguably the *Midland Expressway* judgment) and to retain the risk-profile and pass down of risks and obligations which have become a feature of so-called 'Equivalent Project Relief' (EPR) provisions in PFI sub-contracts.[1]

1.2 Many of these recommended contractual devices are not new and have been inserted in PFI sub-contracts since the enactment of HGCRA. The Committee has noted that irrespective of whether or not any conclusions can be drawn from the *Midland Expressway* judgment as to the general judicial approach to enforcing the contractual devices referred to in Sections 2-3 below, the majority of law firms did not provide legal opinions as to their enforceability prior to this decision.

1.3 The Committee has therefore concluded, in light of current case law, that it is unable to provide definitive guidance that any of the contractual mechanisms suggested in Section 2 or Section 3 are certain to survive a challenge based on HGCRA s.113(1), as this may invoke a wider policy-based initiative to strike down all attempts to circumvent the provisions of HGCRA irrespective of the rationale presented for the parties agreeing to the mechanism(s)[2]. Accordingly, the recommendations set out in this Guidance should be regarded as such and not as 'cast-iron' contractual solutions to the conflict summarised in the Background Paper.

1.4 The contractual devices suggested in this Guidance are of course only one approach to the conflict addressed in the Background Paper.

The other approach would be to extend the current HGCRA Scheme for Construction Contracts Exclusion Order so that it embraces not only PFI project agreements (to which the whole 'pay-when-paid' concept is largely inapplicable anyway) but also first-tier sub-contracts on PFI projects.

The extension could include a financial threshold or a contracting-out provision for those who positively wish to implement the entire Act.

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[1] Proponents of the policy objectives of HGCRA might argue that HGCRA should always be paramount and that therefore the limited recourse funders of PFI projects should moderate their traditional requirements and accept that PFI first-tier sub-contracts are entitled to the full protection of HGCRA s.113. The Background Note sets out the continuing rationale for maintaining funders traditional requirements. However, it is possible to envisage situations where this rationale will not be applicable (for example, due to different financing structures). Clients would expect to be guided by their legal counsel on these situations as well as through discussions with their funders.

1.5 This legislative approach is understandably the more attractive approach to the majority of private sector sponsors and funders of PFI projects in preference to the often lengthy and complex contractual mechanisms which otherwise have to be adopted and the inevitable additional costs this creates. Additionally and aside from the lack of certainty associated with these mechanisms referred to in paragraphs 1.2 and 1.3 above, it remains unsatisfactory for there to be legislation pursuant to one Government policy (fair payment procedures for the construction industry) whilst the implementation of another policy (PFI/PPP) requires that legal counsel is immediately instructed to neutralise that legislation.

1.6 The Committee endorses such a legislative change. It included this proposal in its submission in 2005 to DTI as part of the consultation exercise over reform to HGCRA. The Committee intends to bring this proposal to DTI's attention again through publishing this Guidance.

2. BEST PRACTICE RECOMMENDATIONS

Unless and until any such legislative changes become effective, the Committee recommends use of the contractual devices set out in this Section. These recommendations should of course only be considered with reference to the assumptions and warnings set out in paragraphs 1.1-1.3 above.

2.1 Multi-tiered approach

The Committee recommends a 'tiered'/'waterfall' approach using some or all of the mechanisms set out in paragraphs 2.2-2.5 below. The reasons for this are:

- To evidence the commercial agreement of the parties to achieve the intended risk-transfer (i.e. so as to encourage the Court to give effect to that commercial agreement and/or to view any challenge to it as unmeritorious).
- More simply, so that if any particular mechanism is rendered ineffective by policy-inspired or other application of HGCRA, the next can be applied.
- To create a disincentive to challenge. It will be noted that the various mechanics inevitable lead to variations in the timing of payments. Success in challenging the first tier could, for example, lead to the due date being deferred if a subsequent tier remains intact. It is however, important that the right to bring a challenge remains intact at all times and that there is no prevention of the right to refer disputes to an adjudicator.

2.2 'Entitled-when-entitled'

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[2] It is, however, also the view of the Committee that the steps suggested in section 2 below would stand the better chance of doing so.

Most mechanisms will incorporate a first tier linking the passed-down payment entitlement to the project agreement to some extent. Despite the remarks in *Midland Expressway* about a similar clause being "circumlocution" and equivalent to a pay-when-paid clause, it is possible that a differently drafted clause limiting the entitlements of the sub-contractor to those which it has been independently established that the project company is entitled to be paid by the public sector authority (irrespective of whether any determination has been made under the project agreement) may be effective.[3]

2.3 **'Parallel/Collateral Loan Agreement /Contingent Funding Agreement'**

This device relies on the exclusion of loan agreements from the ambit of HGCRA[4]. In short, these are agreements entered into at the time of entry into the the sub-contract under which the sub-contractor (or an affiliate) is obliged to loan to the project company the funds necessary to discharge a payment obligation rendered unconditional through the failure of a pay-when-paid/entitled/certified provision. That loan is then repaid on receipt of and in the amount of the relevant funds paid by the public sector authority.

It is usually considered that this mechanism is more 'robust', if the loan agreement is entered into by the sub-contractor's guarantor or an affiliate company or, indeed, some other third party rather than the sub-contractor itself.[5] The reason for this is that where the loan agreement is entered into by the sub-contractor a view could be taken that it is insufficiently independent of the sub-contract and that therefore it could be regulated as part of the 'construction contract' under HGCRA (particularly in light of the 'purposive' interpretation of HGCRA adopted by the Court in *Midland Expressway*).

However, it has not always been possible to persuade the guarantors of PFI sub-contractors to enter into these loan agreements and conversely, arguments have been made that where the loan agreement is entered into by the sub-contractor this affords the project company better opportunities of setting off its entitlement to the loan against the obligation to pay the corresponding relevant payment to the sub-contractor. This avoids the project company being required to enforce the loan agreement in the event of a s.113 inspired challenge to the payment procedures - loan agreements do not typically include fast-track dispute procedures matching the dispute regimes of the sub-contracts. A further alternative is a tripartite loan agreement.

2.4 **'Deferred Payment'**

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[3] Alternative first-tier approaches which are used include 'pay-when-determined' provisions, 'pay-when-certified' (see paragraph 3.3) or even direct 'pay-when-paid' clauses notwithstanding in the last case that this would seem to directly fall foul of s.113 (1) HGCRA. The thinking behind this presumably is that other more robust mechanisms can be applied in the event of a challenge to the first tier, but that assuming that no challenge is ever made the primary contractual agreement might as well be kept simple.

[4] Another mechanism related to the loan-back structure is to oblige the parent company of the construction contractor to purchase (more) shares in the Project Company instead of providing a loan. These shares would not have voting rights attached. Alternatively the sponsor entity related to the sub-contractor may be obliged to have shares in the Project Company held by other sponsors "put" on it. However, the complexity of these devices relative to the Parallel Loan structure indicates it would be less attractive.

[5] An affiliated company might, for example, be entering into other contingent funding support arrangements for the Project). As to third parties, to date surety companies have sought to avoid covering parallel loan agreements as these are regarded as 'financial guarantees' and outside their reinsurance arrangements.

This provides for the project company's obligation to pay its sub-contractors an EPR related payment, even if unconditional, to be postponed for an agreed period. The period is often 1-2 years to enable the project company to have sufficient time to take steps (including potentially pursuing, dispute proceedings with the public sector authority) to have sufficient funds prior to the payment date.

This mechanism may be applied on a stand-alone basis (alongside a separate provision (capable of being severed from the sub-contract) for earlier payment if the project company receives payment itself) or as a fallback mechanism should one or more of the other tiers of protection fail. The basis for this mechanism operating by way of a 'fallback' is section 113. (6) HGCRA. This provides that *'where a provision is rendered ineffective by subsection (1), the parties are free to agree other terms for payment'* (with the Scheme for Construction Contracts otherwise applying).

2.5 'Clawback'

It is recommended that sub-contracts include a reconciliation mechanism enabling recovery from the sub-contractor in circumstances where the project company has become unconditionally liable to pay the sub-contractor in advance of receipt of the corresponding payment from the public sector authority.[6]

3. ALTERNATIVE APPROACHES

The following mechanisms have also been put forward as possible solutions. They are placed in this section because either they are regarded as more difficult to implement or less likely to survive a serious challenge to their effectiveness.

3.1 'Subordination'

This device subordinates the EPR related sub-contract payments to debt service in the finance documents (probably under the sub-contractors' direct agreements with lenders). This may take the form of an undertaking not to make such claims or a restriction on entitlement unless the project company has adequate appropriate funds to release that payment (for example, by defining relevant funds which must be maintained before that release can be made or using, for example, the thresholds which need to be exceeded for distributions to be made to project sponsors). However, this may not be an effective mechanism during a period when there is no project company income or distributions are prohibited (which, in a classical 'PFI' structure, would cover the construction period), and would not cover equity's legitimate concerns. Also it may be difficult for a funder to prove loss on any breach of the provision. Finally, sub-contractors are likely to view this regime as unattractive if EPR-related payments are 'locked-up' for reasons wholly unrelated to their sub-contract performance and payment by the public sector authority.

This device has similarities to the parallel loan regime referred to above in that it deals with the issue in a document which should be outside of the ambit of HGCRA. As has been seen, there are barriers to successful implementation, although one advantage is that

[6] Effectively, this is to ensure that ultimately there is no mismatch between the amount received under the Project Agreement and that paid under the sub-contract, where it is not possible to avoid the cashflow risk of having to pay the latter first.

the contractor's parent company does not need to be involved in the structure (which may be an issue for some corporates with the parallel loan device). A variant is to join in the equity providers (assuming they are unrelated to the sub-contractors) as beneficiaries of the undertaking.

3.2 **'Joinder'**

The intention of this mechanism is to consolidate dispute resolution at first tier sub-contract and project agreement levels to avoid different results in relation to similar issues. However, Government entities have historically been resistant to such provisions due to a reluctance to become embroiled in the project company's disputes with its sub-contractors. Moreover, such provisions are likely to be difficult to enforce in connection with adjudications given its fast-track nature. Where joinder is not possible, it is common to include best endeavours obligations that related disputes should be heard by the same adjudicator and arbitrator (if relevant). This will not, however, necessarily secure the same result in the separate proceedings.

3.3 **'Pay-when-certified'**

This device typically provides that the obligations to make EPR-related payments under a sub-contract are conditional on the occurrence of an event or events other than the simple receipt of equivalent payment under the project agreement (for example, entitlement to payment occurring or certification of the relevant payment). As project agreements do not ordinarily allow for certification of the entitlements of sub-contractors, this can lead to provisions requiring a certification of receipt by the project company of the relevant payment. There is a clear risk that unless there is a clear commercial purpose to the certification procedure, these clauses may be vulnerable to attack for being equivalent to 'pay-when-paid' provisions.

3.4 **'No Challenge' Undertaking**

This takes the form of a simple undertaking on the sub-contractor's part not to make a challenge against any EPR payment provisions. Whilst it is unlikely that the Courts would enforce such an undertaking, it is possible that such an undertaking, if supported by performance security from the parent company, may give some comfort to funders.[7]

[7] This comfort may be illusory. If there is ultimately no underlying liability on the part of the Contractor, the beneficiary of the performance security may have a duty to account for any call made on the security.

BACKGROUND PAPER

1. PFI SUB-CONTRACT RISK ALLOCATION STRUCTURE

Since the introduction of the Private Finance Initiative (*PFI*), the Government has been committed to the use of PFI as a procurement option where this offers value for money. In March 2006, the Government/HM Treasury reaffirmed this commitment by issuing its policy statement "PFI: strengthening long-term partnerships".

PFI transactions have traditionally been structured so that the design and construction, facilities management and other operational and/or maintenance obligations and entitlements of the thinly capitalised project company under the project agreement are, as far as possible, passed down to the sub-contractors via their respective sub-contracts. This risk allocation is a widely accepted feature of the PFI structure - risks are "flowed-down" to those best able to manage them, so protecting the project company against the consequences of any relevant risk occurring.

In order to effect such risk allocation, PFI sub-contracts (which to a large extent often replicate the relevant provisions in the project agreement) contain provisions often termed "Equivalent Project Relief" (*EPR*) clauses. Lenders are reluctant to risk the project company being in default, simply because its income does not match its payment obligations under the sub-contracts[8]. Accordingly, these provisions seek to ensure that, wherever the sub-contractor's rights and obligations are based on provisions equivalent to those in the project agreement, the sub-contractor's entitlement is no greater and no less than the project company's relevant entitlement from the public sector authority under the project agreement. Such clauses have become standard in the PFI industry and have gained market acceptance.[9]

2. SECTION 113(1) HGCRA

"A provision making payment under a construction contract conditional on the payer receiving payment from a third person is ineffective, unless that third person, or any other person payment by who is under the contract (directly or indirectly) a condition of payment by that third person, is insolvent"

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[8] This is not universally applied. Claims under sub-contracts which arise out of elective Project Company variations or independent Project Company default are generally not subject to this regime. Even in relation to other EPR related claims, a degree of latitude has sometimes been allowed (e.g. a right to terminate if sums exceed a certain threshold).

[9] There is a wider benefit arising from these mechanisms. The passing of risk away from a PFI Project Company is regarded as having a positive impact on funders' perceptions on a project's financial viability, thereby enabling greater leverage, reducing the overall cost of finance and the affordability of the project to the Public Sector.

This provision was enacted to take account of the legitimate concerns of sub-contractors, specialists and suppliers, who had traditionally borne the brunt of so-called 'pay-when-paid' provisions in the main contractors standard forms[10].

However, within a PFI context, the first-tier sub-contractors are in fact typically the 'main' contractors (and facilities management companies) rather than the sub-contractors, specialists and suppliers HGCRA seeks to protect.

Moreover, in many cases these sub-contractors are also investors in the project and so stand to benefit in that capacity from restrictions on their ability to pursue claims as sub-contractors. Even where the sub-contractor does not have an equity sponsor role, it will generally be a member of a bidder group and (subject to the possible intrusion of the procurement regulations) therefore have the ability to negotiate and price the sub-contract on a sole and negotiated basis.

With the advent of HGCRA, it was quickly recognised by those dealing with PFI projects that providing PFI first tier sub-contractors with the full protection of section 113 (1) could have adverse effects affordability of PFI schemes. A limitation on the ability to pass risks down to sub-contractors would oblige sponsors and their funders to make renewed efforts to transfer relevant risks upstream to the contracting public sector authority (further complicating project negotiations). Senior funders would also require the project to equip itself with alternative sources of funding for incurring any incremental sub-contract exposure. The equity nature of the risk inherent in this additional funding would inevitably attract a higher price than conventional senior debt, with predictable consequences for the affordability of the project.

Accordingly, it became commonplace to implement contractual structures, such as those set out in sections 2 and 3 of the Guidance in order to avoid affecting the pricing of contracts, the ratings projects receive and to satisfy the funders. Most of the large PFI/PPP Projects signed since HGCRA became effective in May 1998 have in fact proceeded on this basis with the clauses gaining market acceptance. Where there has been opposition, experience has suggested that the majority of first tier sub-contractors were not, in fact, insistence upon the full application HGCRA provisions as a matter of principle. The main concern seemed to hinge on the cost or inconvenience of circumventing its provisions or, alternatively, on the need to be fully represented in the main project agreement negotiations, in order to ensure that they have the opportunity to influence and understand the nature of the project agreement upon which their pass down rights and obligations depend.

3. MIDLAND EXPRESSWAY

In *Midland Expressway*, it was confirmed that, notwithstanding the EPR provisions in the first tier construction sub-contract, which had the effect that the contractor's claim was deferred until the matter was determined under the project agreement with the public

[10] Prior to HGCRA, the Courts had consistently upheld correctly drafted pay-when-paid clauses and they had become a common feature of construction sub-contracts. The insolvency exception in s.113(1) has been attacked for removing the protection otherwise afforded at the time when it might most be needed by sub-contractors.

sector authority, a project company was not entitled to prevent adjudication taking place on the contractor's claim. This was because the construction contractor was entitled to proceed with adjudication on the basis of its unfettered right to adjudicate under section 108 of HGCRA.[11]

The Judge in the case (Mr. Justice Jackson) also made non-binding comments about the efficacy of EPR provisions, in particular that some might constitute "pay-when-paid" clauses that are rendered ineffective by section 113 of the HGCRA. These included provisions that the contractor was entitled to be paid when the project company was entitled to be paid. In relation to these the judge went on to say that parties could not escape the operation of section 113 "by the use of circumlocution".

Although the case did not consider any of the more sophisticated mechanisms referred to in this Guidance (and the rationale for their inclusion does not appear to have been debated in any length), it has inevitably lead to uncertainty within the PFI industry over whether the Judge’s purposive approach to interpretation of the HGCRA might be followed to the detriment of the PFI market in the UK. The immediate impact of the case on major projects has therefore been:

- To validate and encourage a return to the multi-tiered contractual approach recommended in this Guidance (and not considered in the judgment).[12]
- To ensure EPR provisions in sub-contracts comply with the narrower construction of the case (i.e. that a construction contractor cannot be prevented from referring a dispute to adjudication).

However, a concern remains that should future adjudications and judicial decisions also give precedence to the policy objectives of HGCRA over the original commercial agreement of the parties there could be major implications for the PFI market in the UK. This could affect both the viability of existing deals and on future projects the pricing and carefully crafted risk allocation structures that have evolved in the PFI market over the last 15 years.

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[11] It is not uncommon to see the EPR provisions in sub-contracts supported by waivers of the right to bring procedures at sub-contract level pending determination of a related matter under the Project Agreement. In light of this judgment, it is recommended that these provisions are not included.

[12] Prior to this decision, an increasing degree of latitude could be seen emerging with EPR provisions, possibly due to the inconvenience of the extensive drafting required and absence of challenges by subcontractors. Use of these arrangements will lead to an increase in transactional costs.

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