

CERTIFYING PAYMENTS UNDER THE CONSTRUCTION CONTRACTS ACT 2002

The Court of Appeal sheds light in
George Developments v Canam Construction

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There must be a "cashflow" in the building trade. It is the very lifeblood of the enterprise.

Lord Denning MR in
Dawnays Ltd v FG Minter [1971] 2 All ER 1389

It is now just over two years since the Construction Contracts Act came into force, and it is a fair time to consider how the legal profession and the legal system as a whole has fared in giving effect to its expressed intent of protecting cashflows.

Common Law Background

Historically, the Courts considered that payment, under a lump sum building contract, was only properly due once the work had been completed in accordance with the contract, and the final price and any deductions or additions determined. Any payment made along the way was strictly *on account* and, as it might be subject to further adjustment for defective work, retentions, damages, differing quantities or variations, the courts were reluctant to give any particular force to interim payment certificates issued by the architect.

Then along came Lord Denning with his fine rhetoric and impeccable logic in *Dawnay's* case (see *quote above*), effectively trying to give payment certificates a higher status, akin to letters of credit, or bank cheques. For an owner to fail to give effect to a payment certificate, issued by an independent professional in terms of a construction contract, was a grave sin in Denning's eyes, and should be actionable as such.

Within 3 years of Lord Denning's decision, as in many of his Lordship's more considered determinations, the House of Lords was disinclined to follow his lead. In the important case of *Modern Engineering (Bristol) Ltd v Gilbert-Ash (Northern) Ltd* [1974] AC 689, the House of Lords overturned *Dawnay's* case, reaffirming the common law position that progress payments are just that and nothing more - payments on account of a finally determined lump sum price, which is only properly due once the works are complete.

Interestingly, the House of Lords was prepared in *Modern Engineering* to accept that withholding interim payments could constitute a penalty, in the same way that liquidated damages which are not a genuine pre-estimate of loss are also a penalty. This however, simply meant that the contractor was free to challenge the failure to pay as a breach of contract, and would only receive his money at the end of a lengthy, expensive and uncertain litigation process. Their Lordships were not prepared to accept that interim payment certificates should be given any weight, on their own account.

Construction Contracts Act 2002

The Act seems to have taken us the full circle.

The general policy set out in the explanatory notes issued with the Construction Contracts Bill was introduced into the House in 2001 included the following statement:

This Bill is intended to facilitate prompt and regular payments within the construction industry. Typically, construction industry contracts provide for work to be paid for after the work has been carried out. Payments are usually made by instalments as the work progresses, but they are very seldom made in advance. This pattern of payments often means that a developer, principal or head contractor with cash flow problems may deliberately delay payment for work done and, in effect, use those further down the contractual chain (for example subcontractors) to partly finance the construction project. It also means that if a developer or principal becomes insolvent, head contractors and subcontractors may not be paid at all for the work that they have already carried out.

This approach was carried over into the Act in section 3 which provides, in part, that the purpose of the Act is *to facilitate regular and timely payments between parties to a construction contract*. There are other general policy objectives in the Act, but this article focuses particularly on how progress payments are to be assured, and how the Court of Appeal perceived this objective is to be achieved in practice.

Scheme of the Act

The procedures under the Act should be well known, by now.

The parties to a contract are free to decide between themselves the number, frequency, timing of procedures and method of calculation of instalment payments (*section 14*), but the balance of the Act is mandatory.

In the absence of agreement to the contrary, the Act provides for monthly claims for work carried out, assessed at the rates in the contract (if any), or based on reasonable value (*section 17*), with payment to be made within 20 working days after receipt of the payment claim (*section 18*).

If the owner disagrees with the claim, it may issue a payment schedule identifying the amount it thinks is properly due under the contract (*a scheduled amount*) within the 20 working day time period (*sections 21 & 22*). It is, of course, open to the contractor to dispute any withholding under a payment schedule, but this is under either the dispute procedures in the contract or a referral to adjudication under Part 3 of the Act, rather than by challenging the contractor's entitlement to receive its instalment payment.

If the owner then fails to pay either the scheduled amount or, if no payment schedule is issued, the amount claimed by the contractor within the prescribed period, such amount becomes a debt due to the contractor (*see sections 23 & 24*). Even if the owner has good grounds for not paying the amount withheld, it can be recovered by application to court without any regard for any counterclaim, cross-demand or set-off (*section 79*).

In practical terms, this simply means that the owner has one opportunity to review progress claims, and that is by issuing a payment schedule.

This one opportunity is, of course, until the next payment claim is received, when a further payment schedule may be issued. Payment claims in the building industry are generally cumulative, which means that the claim will be for all work undertaken, with credits for payments made to date. Scrupulous contractors will identify matters which have been the subject of withholding from previous payment schedules and are under dispute.

So, while the consequences of a failure to pay a scheduled or claimed amount may seem harsh, missed deductions may be rectified in the next round of payment claims. In this way, the Act genuinely enables the contractor to secure its cashflow, without completely prejudicing the owner's right to ensure that the correct amount is ultimately paid.

Payment claims

Payment claims must:

- (a) be in writing, and
- (b) identify the relevant construction contract, and
- (c) identify the work and the period to which the claim relates, and
- (d) indicate the amount claimed and the time for payment, and
- (e) set out the manner in which the claimed amount was calculated, and
- (f) state that the claim is made in terms of the Act, and where the claim is to a residential occupier, set out, in the prescribed form, the process for responding and the consequences for failing to respond.

These requirements are cumulative and mandatory (*section 21*).

Payment Schedules

The unhelpfully named *payment schedule*, formerly what used to be referred to as the payment certificate, must:

- (a) also be in writing, and
- (b) identify the payment claim to which it relates, and
- (c) indicate the amount the owner proposes to pay to the contractor in response to the payment claim (the equally unhelpful *scheduled amount*),

and where the scheduled amount is less than the amount claimed, the payment schedule must also indicate:

- (d) the method of calculation of the scheduled amount, and
- (e) the reasons the scheduled amount is different from the claimed amount, and
- (f) the reasons for any withholding.

These requirements are also mandatory (*see section 21*).

It is clear from the Act that deductions or withholding by the owner for set-off, counterclaim and cross demand are not prohibited under this procedure, provided they are justified under the contract or at law, and are raised in the payment schedule. The contractor can then raise a dispute under the contract procedures or adjudication under part 3 of the Act.

However, only the undisputed part of the claim, the *scheduled amount*, can be recovered as a debt due under summary proceedings.

Early Attempts

It is fair to say that, with notable exceptions, neither the legal profession nor the courts have shrouded themselves in glory in its early attempts to enforce the provisions of the Act.

TUF Panel Construction Ltd v Capon

The first case turned on payment for the delivery of concrete panels. There were a number of diverting issues relating to the identity of the developer and the use of a number of different companies, which will be familiar and entertaining to many, but the main point of dispute was that payment claims had been made and no payment schedule issued.

The developer declined to pay, claiming the right to make a number of deductions under the contract, so the contractor issued proceedings for summary judgement for the withheld amounts.

In a laudable judgement in the District Court on Auckland's North Shore, Judge Wilson QC commented (at para 31):

In my view the policy of the Act ... establish[es] that ... the claims for progress payments crystallise once a payment claim has been issued in respect of the work to which the payment claim relates, provided only that it meets the requirements of form under s20 of the Act and assuming, as here, that no payment schedule is forthcoming.

He then issued judgment for the contractor for the full amounts claimed with interest.

The contractor then endeavoured to extract payment from the developer to no avail, and so the contractor commenced bankruptcy proceedings against him. The developer then issued alternative proceedings against the contractor, applied for a stay of the bankruptcy proceedings and offered to issue a bank security for the amount claimed. Regrettably, an Associate Judge of the High Court in Auckland granted the stay.

This finding rather defeated the purpose of the Act and ignored the fact that it had always been available to the developer to issue a payment schedule, and once that time had passed, to pay the amount owing and put the matter into dispute or apply for adjudication. The choice to fight the bankruptcy was the developer's, and he was in a position to avoid it.

Rapaki Group v Energysave

In the second case (actually the first in the High Court, also before an Associate Judge), the Associate Judge was persuaded to stay the winding up of a company following a statutory demand, also based on a payment claim, though this time following an adjudicator's determination.

The Associate Judge set aside the statutory demand on the basis that there was underway a judicial review of the finding of an adjudicator, which rather flies in the face of

the express wording of section 60, which provides that adjudicator's determinations are binding and to be given full effect even though a party may have *applied for judicial review*.

In the first two cases before the High Court, the contractor was left at a cashflow disadvantage while the dispute was determined.

O'Connor Holdings v ACE Builders Construction

Judge Wilson QC had a further opportunity in the North Shore District Court, this time involving a labour hire contract.

This case also involved unanswered payment claims, and the Judge again found for the contractor.

Court of Appeal in *George Developments Ltd v Canam Construction Ltd*

In February 2005, the application of the payment procedures under the Act came before the Court of Appeal for the first time.

George had appointed Canam for an apartment development in Parnell. A year or so into the contract, payment claim 12 was disputed, giving rise to the part payment of that invoice. The disputed amount was referred to adjudication. Prior to the adjudicator releasing his determination, Canam issued payment claim 15, which included the disputed amount. George failed to respond with a payment schedule within the statutory timetable.

There were a number of other claims and proceedings, but the point of interest is that the payment claim was perhaps not entirely in accordance with the provisions of section 20, and the claim was arguably over inflated by a significant sum (the disputed amount subject to the adjudication). This latter point, incidentally, was corrected by Canam seeking enforcement by summary judgement of only the sum it considered as being properly due, rather than the full amount claimed in the payment claim.

Canam succeeded in the High Court, and George appealed, and the judgement of the court was delivered in April 2005.

The issue the Court of Appeal focussed on was whether or not Canam's payment claim complied with the requirements in the Act. The particular issue in contention was whether the claim identified the work with sufficient clarity and the manner in which Canam calculated the claimed amount in terms of section 20(2)(c) & (e).

Construction work and the relevant period

In relation to the first issue, the Court considered whether it was acceptable to include payment for work carried out prior to the period to which the claim related, how particularly such work needs to be itemised and if it was permissible to include in the claim anything other than for physical work – ie a sum for delay using day rates for extensions of time.

The Court looked at accepted industry practice of using cumulative payment claims, and the practice of the parties, and observed that it would be artificial to require claims to be discrete, relating only to work done within the relevant period. That would involve a *technocratic* and *formalistic* reading of the Act which would *undercut Parliament's intent that cashflows be maintained*.

In determining whether the claim was made with due particularity, the court was influenced by the practice of the parties, and what was generally understood between them. There was no lack of particularity which could not be clarified between the parties.

On the issue of the delay claim, the court observed that the force of the Act *cannot be limited to claims for physical work actually done, as opposed to costs which inevitably arise from carrying out the work.*

Calculation of claimed amount

On the issue of the calculation of the amount claimed, the Court noted that it would be preferable for the claim to identify items in dispute and payments which had already been certified, but accepted that the claim was sufficient for the purposes of section 20(2)(e).

It was reasonable, in the Court's view, to include sums claimed in previous months, and responsible for it not to seek judgement for the amount subject to the adjudicator's determination.

While the issues covered by the Court of Appeal were relatively narrow, and not particularly complex, the case is important in the way in which the court adopted the wording and reasoning favoured by Lord Denning in *Dawney's* case, as reflected in the general policy of the Act, quoted above.

Postscript

The proof of any leading case is the way in which it is subsequently applied.

In early April 2005 (some 8 days before the Court of Appeal delivered its judgement in *George v Canam*), the case of *Solidcrete Technology Ltd v First Pacific Investments Ltd* was heard in the District Court in Auckland.

The case turned not on the formal requirements of a payment claim, but on whether or not a payment schedule (issued for the owner by its project managers) complied with the Act.

Delivering his judgement on 13 May 2005, Judge Joyce QC looked at the pattern of conduct between the parties and observed that it would be *artificial and illogical to ignore the present set of surrounding circumstances and pattern of conduct.* Citing the Court of Appeal in *George v Canam*, the Judge commented (at para 68):

... the key is the provision of sufficient information to make clear the manner in which the amount claimed has been calculated. If the response is an adequate response to the degree of particularity of the payment claim then the claimant should have no cause to complain. The enquiry is contextual.

Hopefully this is a sign of the future application of the Act, and the preservation of cashflows upon which the industry is dependent.

Role of the Architect

So, where does the Architect fit into all this?

There is no recognition in the Act of the role of the independent architect/engineer. The Act simply outlines the respective rights and obligations of the parties to the contract – the

owner and the contractor. As the architect is not strictly a party, this is of little consequence. The architect's only role is as owner's agent, and to the extent of his or her authority, he or she will issue payment schedules under the contract on the owner's behalf, or not as the case may be.

In this context, the architect can only issue a payment schedule in accordance with that delegated authority. As sums are often withheld from instalment payments on commercial issues between the owner and the contractor, it seems to me that the architect is duty bound to check any payment schedule with the owner before it is issued. Especially as the payment schedule provides the owner with its sole opportunity to legitimately make any deductions from interim instalments of the contract price.

However, as the architect's role is defined by contract, the position becomes slightly more complex where the traditional dual role is adopted. This role is frequently expressed as being:

- (1) as expert adviser to and representative of the owner (ie, as agent, subject to the terms of any delegation), and
- (2) independently of the parties, and impartially and fairly, to make decisions entrusted to him or her under the contract (which would not normally be qualified by any delegation, or require any approval from the owner).

The second category traditionally includes valuing variations, granting extensions of time, issuing certificates and determining disputes. Most contractors would expect that issuing payment certificates falls into this second category, in which it is relying on the architect's professionalism. However, most standard form construction contracts issued after the Act came into force (eg NZS3910:2003) place the issuing of payment schedules in the first category.

If an older form of contract is adopted, or one which takes no cognisance of the importance of the new procedures in the Act, there is a risk that an architect will form the view that a payment schedule is a payment certificate in respect of which it is to exercise his or her independent professional judgement, without the input of the owner.

This issue has not been raised in the case law to date. My expectation would be, however, that the architect's independent role can only extend to matters within his or her competence – ie, the valuation of work done or exercising professional judgement under the contract. Where the owner requires deductions or withholdings from any amount due, it would be incumbent on the architect to include such deductions in the payment schedule.

The difficulty arises where the owner expresses a view, and requires a deduction, in relation to a matter on which the architect believes he or she is acting in an impartial professional manner. In such a situation, the architect must balance the expectations of the contractor that he or she will be fair, against the requirements of the owner as a client and the owner of the works. However, in the final analysis, the architect's entire authority is derived from the owner under the contract. If the owner interferes with the architect's independent professional role, then it is the owner who will be in breach of contract, rather than the architect. Provided the owner understands this, then there is little the architect

can do but comply with the owner's instruction. This, of course, will also depend on the terms of the architect's appointment.

Conclusion

The Court of Appeal has gone a long way to correcting an indifferent start to applying the Act. If the *Solidcrete* case is anything to go by, their guidance has taken hold.

While the courts now appear to have taken a permissive and realistic view of how the procedures in the Act are to work in practice, there are a number of things architects can do:

- ensure that the building contract (and the architect's appointment for that matter) has been drafted or amended to take account of the requirements of the Act, including redefining the role of the architect in relation to certifying payments if the traditional dual role has been adopted,
- review the timings under the contract for lodging payment claims, and issuing payment schedules, and ensure they are realistic and the timeframes for responses engrained,
- adopt a cumulative method of claiming for work to date, so that missed deductions can be caught under later progress claims, and identify in the claim all payments and deductions and withholdings made to date,
- use the standard forms for payment claims and payment schedules where possible (for example, see the form of payment schedule set out in *Smellie's Progress Payments and Adjudication, Lexis Nexis 2003*), and
- ensure that the owner is consulted in relation to all payment schedules before they are issued so that all deductions which the owner is entitled to make are included.

It is, of course, not the end of the world if this approach is not adopted, and a payment ends up in dispute. You may need, however, to explain to an unhappy client why it is that a disputed payment needs to be made to an unworthy contractor, pending the resolution of the dispute either in court or under adjudication.

Fine sentiments about cashflow aside, I know most clients would rather have the money in their account.