

In *C Spencer Limited v MW High Tech Projects UK Limited* the Court of Appeal recently confirmed that payment notices issued in relation to construction contracts under the Housing Grants, Construction and Regeneration Act 1996 (the Act) that do not distinguish between construction and non-construction operations are valid and do not contravene the provisions of the Act. The judgment provides helpful clarity to contractors and employers, and should ensure that parties are not subject to unnecessary costs and complexity when dealing with payment issues. However, this case again raises the question: does the construction and non-construction operations distinction in the Act need reform?

Legal background

Section 104(5) of the Act states: "Where an agreement relates to construction operations and other matters, this Part [the Part that relates to 'construction contracts' as defined at section 104(1)] applies to it only so far as it relates to construction operations."

Construction operations are defined at section 105(1). A narrow, but important, list of non-construction operations is set out at section 105(2) [see box overleaf].

This distinction between construction and non-construction operations has led to the concept of hybrid contracts, which arise where the relevant contract provides for both construction operations and non-construction operations (eg where the exception applies to part of the works).

The dispute

MW High Tech Projects Limited (MW) was engaged to design and construct a power

plant capable of processing refuse-derived fuel produced by commercial and industrial waste. Under a sub-contract (the Sub-Contract), C Spencer Limited (CSL) was appointed to design and construct the civil, structural and architectural works. The Sub-Contract works comprised both construction and non-construction operations.

In February 2019, CSL issued a payment application that distinguished between the sums payable in respect of construction operations and sums for non-construction operations. In response, MW served a payment notice on CSL in which it contended that, in fact, monies were due to MW, chiefly as a result of claims for delay it had against CSL.

In its payment notice MW did not distinguish between sums due in relation to construction operations and non-construction operations. CSL argued that the payment notice was invalid because it did not make this distinction. CSL, therefore, contended that they were entitled to the sum claimed in their interim application. MW argued that its payment notice complied with the contractual payment regime between

the parties and was compliant with the requirements of the Act; it was, therefore, a valid payment notice. At first instance, O'Farrell J found in favour of MW.

The judgement

CSL appealed, arguing that the phrase 'only so far as it relates to construction operations' in s.104(5) of the Act had to be read into every section of the Act, including those dealing with payment. CSL argued that it followed, in relation to hybrid contracts, that a failure to stipulate within the overall sum notified in the payment notice the amount relating to construction operations, was a failure to comply with the Act.

Coulson LJ dismissed the appeal, concluding O'Farrell J had been correct to reject CSL's argument. In reaching his conclusion, Coulson LJ noted:

1. The Act identifies minimum standards that construction contracts must adhere to.
2. There is nothing in the Act which requires, in hybrid contracts, payment terms to provide a separate notified sum in respect of solely construction operations. If such a distinction



Legal view: hybrid contracts

The question of construction operations or non-construction operations is discussed by Partner and London Dispute Resolution Co-head **Rebecca Williams** and Senior Associate **Alexander Creswick** of Watson Farley & Williams

was important, the Act could have provided for this. If such a distinction was required, then it would give rise to two notified payment sums (one for construction operations and one for non-construction operations). It followed that the Sub-Contract complied with the Act because there was no requirement to break down sums due in relation to construction operations.

3. CSL's argument that the phrase 'only so far as it relates to construction operations' in s.104(5) of the Act had to be read into every section was rejected. The Act could be construed perfectly well without reading these words in.
4. The parties were at liberty to extend the statutory payment provisions to non-construction operations. However, this did not require the parties to differentiate between different aspects of the works under the Sub-Contract.
5. The distinction between construction and non-construction operations only arises when there is a dispute because it is only in the case of construction operations disputes that there is a statutory right for the dispute to be referred to adjudication. While the Sub-Contract drew a distinction between construction and non-construction operations in the adjudication clause, no such distinction was drawn in the contractual payment mechanics, indicating that the parties were happy to rely on the payment provisions derived from the Act.
6. O'Farrell J's decision was in accordance with the existing authorities and the purpose of the Act (ie certainty and transparency of stage payments). If the parties were required to undergo two

separate processes for construction and non-construction operations, that would add a level of unwanted uncertainty, complexity and cost.

Conclusions drawn

Coulson LJ's judgment provides welcome clarity to contractors and employers issuing payment applications and notices. A requirement that parties separate payment notices into construction and non-construction operations could well lead to uncertainty and potential disputes over the sums allocated towards each category.

This decision is particularly relevant for those involved in the power generation sector, where works will often be conducted under hybrid contracts involving both construction operations (eg site clearance) and non-construction operations (eg erecting steelwork for the purposes of supporting machinery on a site where the primary activity is power generation).

The decision also emphasises the importance, when drafting payment provisions in construction contracts, of complying with the minimum requirements as set out in Act. If terms fail to meet these requirements, the Scheme for Construction Contracts will automatically apply.

The distinction between construction and non-construction operations in the Act was a result of lobbying by specific sections of the construction industry to exclude such sectors from the Act's scope. It has been suggested that the government agreed to this distinction because they were persuaded that the excluded sectors were already operating satisfactory contractual arrangements. However, the distinction has been criticised as lacking "obvious rationality" and that "the definition of 'construction operations' verges on the absurd".

The distinctions in hybrid contracts between works included and excluded pursuant to the Act are arguably artificial, with limited reasoning for the

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difference in classification of different operations. By way of example, “installing plant for nuclear processing, and power generation, or for water and effluent treatment is excluded but not plant for an incinerator”. Moreover, the confusion caused by the distinction in hybrid contracts and how such contracts can be reconciled with the Act has frequently led to disputes between stakeholders in the construction industry, as demonstrated by the C Spencer Ltd case.

Turnkey EPC contracts, such as for the construction of a power plant, will often qualify as hybrid contracts since they almost invariably contain both construction and non-construction operations. This means such projects suffer the inherent uncertainties created by the construction/non-construction


operations distinction under the Act. For such high-value and complex projects, this ambiguity and scope for dispute is arguably not in the parties’ or the public’s

interest. In practice, parties to such contracts frequently ensure they are compliant with the Act, even if the project in broad terms would fall outside its scope, but it seems inconsistent with the aims of the Act to expect parties to have make specific provision in their contracts for a problem they would not otherwise be in.

The main aims of the Act were to improve cash flow in the construction industry and streamline the dispute resolution process. The Act has, on these accounts, been viewed as a considerable success. However, maintaining the artificial distinction between construction and non-construction operations has led

to multiple disputes and the costs and time involved in such disputes can be considerable for often stretched project teams.

As Coulson LJ acknowledged in C Spencer: “In the last 20 years, too much time and judicial resource has been spent grappling with the problems created by such hybrid contracts, of which this appeal is but one example. But until the Act is amended to do away with these unnecessary distinctions, the courts have to do their best to resolve the resulting, self-inflicted problems.”

There is, therefore, a compelling argument for the reform of the Act. The artificial distinction between construction and non-construction operations should either be removed, narrowed or clarified so as to expressly include or exclude hybrid contracts. This would avoid the unsatisfactory scenario of some aspects of the same project being covered by the Act and other aspects being excluded. 

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Construction vs non-construction operations

Construction operations are defined at section 105(1) to include:

- a. construction, alteration, repair, maintenance, extension, demolition or dismantling of buildings, or structures forming, or to form, part of the land (whether permanent or not);
- b. construction, alteration, repair, maintenance, extension, demolition or dismantling of any works forming, or to form, part of the land, including (without prejudice to the foregoing) walls, roadworks, power-lines, [F1 electronic communications apparatus], aircraft runways, docks and harbours, railways, inland waterways, pipe-lines, reservoirs, water-mains, wells, sewers, industrial plant and installations for purposes of land drainage, coast protection or defence;
- c. installation in any building or structure of fittings forming part of the land, including (without prejudice to the foregoing) systems of heating, lighting, air-conditioning, ventilation, power supply, drainage, sanitation, water supply or fire protection, or security or communications systems;

- d. external or internal cleaning of buildings and structures, so far as carried out in the course of their construction, alteration, repair, extension or restoration;
- e. operations that form an integral part of, or are preparatory to, or are for rendering complete, such operations as are previously described in this subsection, including site clearance, earth-moving, excavation, tunnelling and boring, laying of foundations, erection, maintenance or dismantling of scaffolding, site restoration, landscaping and the provision of roadways and other access works;
- f. painting or decorating the internal or external surfaces of any building or structure.

A narrow but important list of non-construction operations, set out at section 105(2), include:

- a. drilling for, or extraction of, oil or natural gas;
- b. extraction of minerals or construction of underground works for this purpose;
- c) assembly, installation or demolition

of plant or machinery, or erection or demolition of steelwork for the purposes of supporting or providing access to plant or machinery, on a site where the primary activity is:

- i. nuclear processing, power generation, or water or effluent treatment; or
 - ii. the production, transmission, processing or bulk storage (other than warehousing) of chemicals, pharmaceuticals, oil, gas, steel or food and drink.
- d. manufacture or delivery to site of:**
- i. building or engineering components or equipment,
 - ii. materials, plant or machinery, or
 - iii. components for systems of heating, lighting, air-conditioning, ventilation, power supply, drainage, sanitation, water supply or fire protection, or for security or communications systems, except under a contract which also provides for their installation;
- e. the making, installation and repair of artistic works, being sculptures, murals and other works which are wholly artistic in nature.**