The Construction Market: Next Steps

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Adjudication: Time for a new approach in construction?

Mashreq Bank recently published a 'Construction Think Tank' report on recommendations for change in the construction industry in the UAE ('Report'). The Report, which was compiled with input from leading entities in the industry, explores ways to increase productivity and adopt new technologies but recognises those innovations are unlikely to be adopted whilst cash-flow remains a widespread problem within the industry.

To address those cash-flow problems the Report recommends:

- Rebalancing the way risks are shared by the parties, through:
  - an industry wide move away from adversarial attitudes in favour of placing risk with the party best placed to manage that risk in the interest of the project;
  - introduction of industry wide standard contracts with a balance risk profile; and
  - a drive to improve contract administration.
- Statutory intervention to codify:
  - key terms used in the construction industry; and
  - payment and certification processes and providing for fast-track adjudication.

The Report's focus on cash-flow is not surprising. There has been significant recent commentary around the need for change in this area for some time. Further, recent government action (such as the Abu Dhabi government circular requiring 30 day payment terms in all contracts within government supply chains and the recent open letter from Sheikh Mohammed in Dubai calling for changes in the construction and real estate industry) may be seen as an acknowledgment of and willingness to address issues within the industry at the highest level.

In this article, we consider whether, in the absence of evidence of a significant shift in attitudes, there should be a statutory intervention to change industry practice and place the industry on a sustainable footing.

A Shift in Attitudes?

In any construction project, there is a substantial mutual goal for the parties, namely, completion of the project in accordance with the requested standard, without delay and without unplanned costs:

- for the employer, until this occurs, they cannot commercially exploit the works; and
- for the contractor, completing the works unlocks full payment and releases their resources for other projects.

Despite the above, parties to construction contracts remain adversarial. Employers continue to seek to transfer as much risk as possible down the supply chain irrespective of the parties' ability to manage that risk. In addition, the lowest price remains the driving factor in many procurement decisions. As a result, contractors submit bids with profit margins too low to absorb the risks they accept in order to win work in an increasingly competitive market.

This approach to contracting does not yield best value for the parties. As the Report notes, *"it is widely proven that awarding construction contracts to the cheapest tender will generally result in the most expensive project due to the additional cost of delays, poor workmanship and repairs."* The rationale behind this statement is likely to be familiar to many in the UAE construction market. A common scenario is:

- a contractor encounters risks it has not priced, this quickly erodes any profit margin or contingency. The margin is expended and cash-flow problems slow the pace of works. Further, the contractor seeks to find savings in the construction of the works;
- delays lead to additional costs which employers are rarely fully compensated for by capped delay damages; and
- where corners are cut due to reduce the contractor's exposure, maintenance costs increase. leaving the employer in a worse position 'in the long run';

A sensible allocation of risk and pricing which takes account of the risk profile will mean the overall 'whole life' cost will be lower despite initial construction costs being slightly higher (whether through a higher tender price or through valid claims for variations and/or compensable delay).

For sub-contractors, 'back to back' payment clauses exacerbate the above issues. It is apparent that the cash-flow issues created by 'back-to-back' clauses and poor contract administration are, in our experience, increasingly being managed by diverting funds (especially advance payments) from one project to finance works on other projects and meet other liabilities. This creates a chain of projects in financial difficulty from an early stage, if the industry is to be sustainable this chain must be broken.

However, from a main contractor's perspective, why would anyone give up the protection of 'pay when paid' terms which can be imposed on sub-contractors without assurance that employers will pay them on time or at all.

It seems, therefore, that change is only likely to occur if it is led by employers looking at 'whole life' costs rather than focusing on the short-term cost of construction.

If such change is not forthcoming, there may be a case for statutory intervention. There is precedent for such intervention in other jurisdictions. The Latham Report (1994) identified similar issues to those above in the UK industry and ultimately led to the introduction of a statutory regime for certification and payment

and adjudication in 1996. Since that regime took effect in 1998 the number of construction cases and in particular payment disputes, being heard in the UK courts has dropped sharply.

Mandatory Contract Terms

The Report suggests a ‘new standard form’ contract with a more balanced risk profile might be part of a solution. In practice a ‘one size fits all’ contract is likely to be difficult to arrive at and it would still, in the absence of restrictions, be subject to amendment.

That said, there could be merit in adopting a new ‘standardised’ form of contract in the public sector to lead by example and encourage best practice. For example, the imposition of shorter payment timescales in Abu Dhabi government supply chains has been welcomed as a positive step and shows a willingness to lead by example.

We suggest it would be better for the industry to retain the freedom to contract as it wishes, save to the extent necessary to safeguard cash-flow and thereby the health of the industry as a whole. This would follow similar interventions in other jurisdictions such as the UK, Australia, Singapore and New Zealand.

By looking to the regimes which have been in place for many years in other jurisdictions (UK 1998, Australia 1999, New Zealand 2002, Singapore 2005), a possible framework for such legislation can be found and adapted to fit the UAE market.

For example, the New South Wales regime:

- prohibits particularly abusive practices such as ‘pay when paid’ or only permitting payment on completion;
- requires contracts to meet certain minimum standards designed to give the contractor certainty as to when payment is due and how much is due;
- incorporates into any contract, which does not meet those requirements, ‘default’ terms to ensure that a contractor will always have the benefit of clear and unambiguous payment terms; and
- incorporates a process whereby the amount which the contractor considers to be due in its payment application is deemed to be the certified amount where the engineer and/or employer fail to engage in the certification process in accordance with the contractual/implied time limits.

Schemes such as that described above ensure that there will always be a certified amount (as the employer (or the engineer) does not have the ability to delay certification)). Further, the contractor has clarity as to why a certified amount differs from the amount claimed in order to bring a claim for the difference if this is in dispute.

The above mechanisms would introduce greater clarity and certainty into certification and payment processes. However, this is of little benefit to contractors if, in the face of an employer who refuses to make payment, they do not have ready access to a dispute resolution tribunal which offers certain, timely and cost-effective redress.

The need for Adjudication

It has been said that there is no need for an additional dispute resolution mechanism given there are already a wide variety of tribunals available in the jurisdiction and contracts already contain complex multi-stage dispute resolution provisions.

In answer to this point, the aims of a statutory adjudication scheme need to be kept in mind. The

overriding purpose of an adjudication scheme is to ensure that cash moves through the supply chain quickly and with minimal interruption. In order to do this, any dispute mechanism needs to:

- be available to the parties at any time without pre-condition;
- be affordable to allow resolution of interim payment disputes of mid to low value;
- produce predictable decisions;
- be capable of producing an enforceable result in a short timeframe; and
- be independent of the parties (including the engineer).

Existing dispute mechanisms do not achieve these aims with cost and timescales often being prohibitive, particularly in the case of arbitration, and with use of those mechanisms being part of a lengthy staged dispute resolution mechanism.

As can be seen above, none of the commonly available mechanisms adequately achieve the purpose of keeping cash moving through the supply chain on an interim basis. When the DAB (and later the DAAB) was introduced by FIDIC there was commentary on the benefits of adjudication. However, use of these processes remains rare in the Middle East. In part, the reluctance to use the DAB/DAAB process is because, without a clear route to enforcing the tribunal's decision, they simply add a layer of additional cost to the dispute resolution process.

However, experience suggests that in many cases the cause of reluctance to adopt the DAAB process is that employers have the upper hand in contract negotiations and it can be in their interest to deny contractors (and in turn sub-contractors) the ability to obtain a decision requiring payment to be made quickly or in a cost-effective manner.

Statutory Adjudication

Statutory adjudication is not a new concept and so we can look to schemes adopted in other jurisdictions in order to understand what works and where improvements can be made so as to tailor such schemes to the UAE market. Given the widespread popularity of the FIDIC forms of contract, it makes sense to adopt provisions which mimic the FIDIC approach to payment and adjudication in so far as is possible. It is also useful to look to those regimes to understand the key components of any such scheme. Those components are:

- adjudications are commenced by giving notice in the same way as arbitration;
- following the issue of a 'referral notice' the parties may agree the identity of the adjudicator or refer the appointment to an appointing body (as is common in arbitration). To ensure the process does not become 'bogged down' in this initial phase strict time limits are imposed for the appointment (seven days from issue of the referral notice);
- once appointed the adjudicator has a relatively short time, in the UK 28 days subject to extension of up to 42 days (or longer if both parties consent);
- the adjudicator has control of the timetable and process, save that both parties are allowed to make submissions and the claimant has the right to respond to the defendant's defence;
- whilst the adjudicator has a wide discretion regarding the process, submissions are usually made in writing and a hearing is often not required;
- decisions have 'temporary finality'. In other words, they are final and binding unless and until the final tribunal (courts or arbitration) issues a decision on the same issue; and
- there is no right to recover costs in adjudication, but the adjudicator can apportion his/her costs between the parties as he/her considers appropriate.

In fact, the DAAB procedure fulfils most of the above criteria and could be adopted as a basis for a mandatory adjudication procedure. In order to be effective, we consider that this would however need to be supported by legislation requiring the process to be used, preventing amendments to move away from

the above principles and ensuring any decision can be enforced.

Procedure

The above process is broadly comparable to arbitration and should be readily given the widespread use of arbitration in the UAE. This suggests that the UAE market could adapt to such a process without difficulty.

There is a ready pool of arbitrators who could serve as adjudicators and no doubt the same nominating bodies as are commonly used in arbitration could, at least initially, nominate suitable adjudicators. This is borne out by the UK experience where specialist adjudication bodies and adjudicators grew out of the arbitration industry in the early years of the regime.

The shorter timescales in adjudication would require parties, nominating bodies and potential adjudicators to engage with and act much more quickly than is typically the case in arbitration processes. However, the simpler procedure and shorter timescale means that, whilst the process is intense overall, a fraction of the resources required for an arbitration is required for adjudication thereby creating significant cost savings.

Temporary Finality

Adjudicators' decisions are binding with 'temporary finality'. Some in the industry might say 'what is the

point of a decision if it can be overturned?' The point is, we suggest, that the process has the overriding objective of keeping cash flowing through the supply chain, and to do so the process must be quick. A shorter, simpler process (e.g. where there is no disclosure or discovery) can lead to results which are incorrect. By stipulating that a decision is temporary but binding until a superior tribunal issues a decision, adjudication allows:

- employers to challenge what they consider to be a bad decision by adjudicators by commencing proceedings in the courts or arbitration in the usual way; and
- contractors are able to secure a decision for payment (if successful) quickly and cost effectively so that decision can be enforced and consequently ensure cash flow.

This leaves a risk that employers will be required to pay money to contractors in respect of a decision which they: (a) do not agree with; and (b) are re-litigating in the courts or arbitral tribunal. This creates a real risk that, at a later date, the employer may overturn the adjudicator's decision only to discover the contractor does not have the funds to repay the employer. Other jurisdictions have considered this risk and have concluded that:

- adjudicators tend to come to the correct decision most of the time while the volume of construction cases in the UK courts and arbitration has dramatically shrunk since the entry into force of the Construction Act in 1998, suggesting most employers are satisfied with the validity of most decisions; and
- the risk of a minority of employers being placed in this position is preferable to the majority of contractors suffering the ill effects of continuing cash-flow problems.

Nonetheless, this will be a serious concern for many employers and larger main contractors and merits further consideration. There may be an opportunity to improve on existing regimes by requiring security for costs in some way where an adjudicator's decision is disputed. However, this must be balanced against re-introducing financial barriers to fast and cost-effective dispute resolution or locking up cash as security which would undermine the overriding objective of the regime – cash flow for the benefit of the project. The New South Wales scheme, as originally drafted, sought to allow payment to be postponed where security for the amount due was provided – however this limited the effectiveness of the regime which was ultimately amended to adopt the UK style 'pay now argue later' approach.

It should be kept in mind that the whole purpose of a 'construction act' is to improve cash-flow and thereby liquidity in the industry. As the benefits of such a scheme takes effect, the risks associated with making payments to parties with a high likelihood of liquidity problems should reduce.

Enforcement and the Courts

All of the above will only be effective if there is a clear route to enforcement of an adjudicator's decision. If there is no clear and unambiguous right to enforce a decision, there is little incentive to committing to a process in the first place.

The simplest way to ensure this is to legislate so that paying parties are required to make payment in compliance with adjudicators' decisions within a fixed timescale. This creates a clear statutory obligation which, if breached, would give rise to a strict liability claim which could be enforced in the courts.

If the purpose of such an act is endorsed by the courts and robustly supported, the adjudication process, coupled with statutory requirements and default provisions in respect of payment, could have a significant positive impact on the liquidity and sustainability of the UAE's construction industry putting it in a position to embrace and lead innovation.

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