Construction Act Review

Construction Operations: Hybrid Contracts

*By Peter Sheridan**

Introduction

The payment and adjudication provisions of the Housing Grants, Construction and Regeneration Act 1996 (the HGCR Act) are applicable to construction contracts.[1] "Construction contract" is defined by reference to construction operations; what are and are not construction operations is governed by s.105.

The way that s.105 works is that it sets out operations that are construction operations in s.105(1) and then sets out in s.105(2) operations that are not construction operations. The operations described in s.105(2) could also fall within the descriptions in s.105(1); the way this is resolved is that s.105(2) is overriding. For ease of reference, these provisions are set out after this introduction.

It is possible for a contract to apply both to construction operations and to matters which are not construction operations; a contract of this type is referred to in this article as a hybrid contract. In a hybrid contract, the HGCR Act applies only to that part of the contract which relates to construction operations.[2]

There is no principle that a contract will be either entirely subject to the HGCR Act or not subject to it. S.104(5) provides: "Where an agreement relates to construction operations, and other matters, this Part[3] applies to it only so far as it relates to construction operations." Ramsey J observed in the *Cleveland Bridge* case "It follows that the statute contemplated a position where one agreement related to both construction operations under s.105(1) and operations which were excluded by s.105(2)."[4] For this reason, there is no principle that each contract in a chain of contracts will be uniformly subject to or not subject to the HGCR Act.[5]

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*Partner, Sheridan Gold LLP.
[1] As defined in s.104 of the HGCR Act.
[2] S.104(5) of the HGCR Act. See also the writer's analysis in CAR at (2006) 22 Const.L.J. 241 of *Gibson Lea Retail Interiors Ltd v Makro Self Service Wholesalers Ltd* [2001] B.L.R. 407 QBD (TCC).

[3] Part II of the HGCR Act, which sets out the statutory provisions relating to construction contracts.
[4] *Cleveland Bridge (UK) Ltd v Whessoe-Volker Stevin Joint Venture* [2010] EWHC 1076 (TCC) at [63].
[5] See *e.g. Palmers Ltd v ABB Power Construction Ltd* [1999] B.L.R. 426; (1999) 68 Con. L.R. 52; [1999] C.I.L.L.1543–1546, TCC; *Comsite Projects Ltd v Andritz AG* [2003] EWHC 958 (TCC). These cases were considered in the writer's article on construction operations at (2006) 22 Const.L.J. 241.

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Hybrid contracts may give rise to issues and complications in connection with both the adjudication and the payment provisions of the HGCR Act.

The adjudication provisions of the Scheme for Construction Contracts, Statutory Instrument 1998 No 649 (the Scheme) apply if a construction contract does not comply with s.108(1) to (4) of the HGCR Act.[6]

The payment provisions of the Scheme apply as provided at s.109(3), in the absence of provision for periodic payment compliant with s.109(1) – (2), at s.110(3), to the extent there is no contractual provision as to dates for payment compliant with s.110(1), at s.110A(5), to the extent there is no contractual provision as to payment notices compliant with s.110A(1) and at s.111(7)(b), to the extent that there is no contractual provision as to the prescribed period before the final date for payment for a pay less notice.

The statutory provisions as to construction operations

Section 105 of the HGCR Act is as follows.

"105. (1) In this Part "construction operations" means, subject as follows, operations of any of the following descriptions

(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, roadways, power-lines, telecommunication 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,[7] power supply, drainage, sanitation, water supply or fire protection, or security or communications systems;

[6] S.108(5) of the HGCR Act.

[7] For example, a sub-contract for mechanical and air conditioning works is a contract for construction operations: *William Oakley v Airclean Environmental Ltd* [2002] C.I.L.L. 1824-1827.

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(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 which 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, earthmoving, 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

(2) The following operations are not construction operations within the meaning of this Part –

(a) drilling for, or extraction of, oil or natural gas;

(b) extraction (whether by underground or surface working) of minerals; tunnelling or boring, 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, lightning, air-conditioning, ventilation, power supply, drainage, sanitation, water supply or fire protection, or for security or communications systems;

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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.

(3) The Secretary of State may by order add to, amend or repeal any of the provisions of subsection (1) or (2) as to the operations and work to be treated as construction operations for the purposes of this Part.

(4) No such order shall be made unless a draft of it has been laid before and approved by a resolution of each House of Parliament."

Case law: adjudication: *Cleveland Bridge*[8] and *Cubex*[9]

Whessoe Volker Stevin Joint Venture (the Joint Venture) engaged Cleveland Bridge as sub-contractor to carry out works at the Dragon liquefied natural gas terminal at Milford Haven. Cleveland Bridge's works comprised project preliminaries, supply, fabrication, delivery and erection of steelwork in the form of pipe racks and pipe bridges, the construction of an equipment room and process area compressor house, including cladding and the painting of all steelwork.

Cleveland Bridge sought to enforce an adjudicator's decision in its favour and the question whether the parties' sub-contract was not a construction contract because certain operations fell within the exception in s.105(2)(c) was relevant to jurisdiction. The Joint Venture resisted enforcement on the basis that the adjudicator did not have jurisdiction.

Cleveland Bridge contended that all the work came within the definition of construction operations in s.105(1) and that only the erection works for the steelwork in the form of pipe racks and pipe bridges potentially came within s.105(2). They submitted that if this element of the work came within s.105(2), it was so small an element that the works were not excluded by s.105(2). They assessed this erection work as 18.2% of the final account value.

The judge found that even if this assessment were correct, there was significant and substantial erection of steelwork, *i.e.* 18.2% is significant and these works fell within s.105(2). The steelwork to the pipe racks and the pipe bridges came within the description of "steelwork for the purposes of supporting or providing access to plant or machinery, on a

[8] *Cleveland Bridge (UK) Ltd v Whessoe-Volker Stevin Joint Venture* [2010] EWHC 1076 (TCC).
[9] *Cubex (UK) Ltd v Balfour Beatty Group Ltd* [2021] EWHC 3445 (TCC).

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site where the primary activity is...(ii) the production, transmission, processing or bulk storage...of...gas..."

The position was accordingly that the parties' contract consisted in part of construction operations within s.105(1) of the HGCR Act and in part of operations which were not construction operations by reason of s.105(2)(c)(ii). Only one dispute had been referred to the adjudicator, who only had jurisdiction to deal with the dispute in so far as it arose under the part of the sub-contract which related to construction operations. The adjudicator decided she had jurisdiction over the whole dispute and made a decision on the whole dispute. In these circumstances, the adjudicator's decision was not valid and could not be enforced. The position on severability, which the writer has considered in detail previously,[10] was at this time at least, in brief,[11] that a decision which is in respect of a single dispute and made partly without jurisdiction is not severable so as to allow the valid part to be enforced. It is doubtful whether the same "single dispute" approach to severability would be taken today.

However, in the recent case *Cubex (UK)*, it was common ground between the parties that if their contract related in part to excluded operations and was thus a hybrid contract, the court did not have jurisdiction to give summary judgment to enforce an adjudicator's decision, by reference to the *Cleveland Bridge* case. This may have been because on the facts of the case severance was not going to work. In the event the contract was not a hybrid contract but was in its entirety a contract that was not for construction operations. It was a contract for the design and supply of doors, which are not construction operations by virtue of s.105(2)(d). The adjudicator's decision was accordingly not enforced.

Case law: payment

Although the *Cleveland Bridge* case was not concerned with the payment provisions of the HGCR Act, Ramsey J noted:

> "It also follows that the right to refer disputes to adjudication under s.108, the entitlement to stage payments under s.109, the provisions as to dates of payment under s.110, the provisions as to notice of intention to withhold payment under s.111, the right to suspend performance for non-payment under s.112 and the prohibition of conditional payment provisions under s.113 will only apply to the sub-contract in this case, in so far as the sub-contract relates to construction operations."[12]

[10] See Severability of Adjudicators' Decisions at (2004) 20 Const.L.J. No.2 at 71; Severability of Adjudicators' Decisions: Revisited at (2009) 25 Const.L.J. No.5 at 376.
[11] The position on severability in detail is outside the scope of this article and will be revisited in a future edition of CAR.
[12] *Cleveland Bridge*, above, at [65].

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In the *C Spencer* case,[13] the question was whether, in the case of a hybrid contract, a valid payment notice for the purposes of s. 111 of the HGCR Act must identify separately the sum due in respect of any construction operations and the basis on which that sum is calculated.

The main contract was for the design and construction of a power plant, capable of deriving fuel from waste. A sub-contract under which MW engaged CSL to design and construct civil, structural and architectural works, was a hybrid contract. CSL's works included construction operations, but also the assembly of plant and erection of steelwork to provide support or access to plant and machinery. The latter works were not construction operations, because they fell within one of the categories excluded from construction operations by s.105(2)(c) of the HGCR Act. It was common ground that the primary activity at the site was power generation.

Initially, the parties operated the interim payment mechanism of the sub-contract without drawing a distinction between payment for construction operations and payment for non-construction operations. A dispute then arose in respect of interim payment and CSL gave notice of an intention to refer the dispute to adjudication. MW raised a jurisdictional challenge that the contractual adjudication provision was limited to disputes in respect of construction operations; the dispute as framed failed to distinguish between the works and associated sums claimed falling within and outside the ambit of the HGCR Act. CSL withdrew its adjudication claim.

CSL then made an interim payment application, for £2,683,617.09, which did distinguish between sums claimed for construction operations and non-construction operations. MW then served its payment notice, with an attached spreadsheet, which indicated a negative sum due to CSL. The sums were not allocated to or divided between construction operations and non-construction operations in MW's payment notice. CSL then claimed the sum of £2,683,617.09 as the notified sum due in the absence of any valid payment notice or pay less notice. MW disputed the alleged debt, arguing that the failure of MW to specify the sums due in respect of construction operations and non-construction operations did not invalidate its payment notice.

The provision of the sub-contract providing for adjudication was expressly applicable only to the extent required by the HGCR Act, *i.e.* only in respect of construction operations.

In respect of payment, the HGCR Act applied only to the construction operations and not the non-construction operations. The parties could have agreed payment provisions in respect of the non-construction operations that were not compliant with the requirements of the HGCR Act for payment provisions. In that event, a payment notice would have to state separately the sums due in respect of construction operations in order to be valid.

[13] *C Spencer Ltd v MW High Tech Projects UK Ltd* [2019] EWHC 2547 (TCC).

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However, O'Farrell J pointed out that the parties were also free to agree that non-construction operations should be subject to the same requirements as those contained in the HGCR Act. Section 104(5) does not preclude the parties from agreeing a contractual payment regime pursuant to which the statutory requirements are applied to both construction operations and non-construction operations.

That was the position in the *C Spencer* case. The judge held that where, as here, a hybrid contract contains a payment scheme that complies with, or mirrors, the relevant provisions of the HGCR Act for both construction and non-construction operations, a payment notice that does not separately state the sums due in respect of the construction operations is capable of constituting a valid notice for the purposes of sections 110A and 11 of the HGCR Act.

A different payment issue had arisen in the earlier *Severfield* case.[14] It was common ground there was a hybrid contract. Severfield was engaged by Duro Felguera to carry out the design, supply and erection of steel structures. Some of the works comprised construction operations, but some of the works were not construction operations because they related to power generation. The parties were seemingly unaware of this distinction as their payment regime was not in accordance with the requirements of the HGCR Act.

The effect of this was that the payment provisions of the Scheme were imported into the contract, but only in respect of the construction operations. Thus the contract had two payment regimes.

Initially, Severfield had in interim application 15 sought payment of £3,782,591.12, making no distinction between construction operations and non-construction operations. There was no valid payment notice or pay less notice from Duro Felguera within the time required under the HGCR Act in respect of construction operations. Severfield referred a claim to adjudication for £2,470,231.97, which it claimed was the element of application 15 relating to construction operations. This claim had succeeded in adjudication, but had failed on enforcement, on the basis that it was arguable the adjudicator had decided various aspects of the claim relating to non-construction operations and did not have the necessary jurisdiction to reach his decision.

In the present case, the position was that Severfield had set out in detail a revised claim for £1,445,495.78, in respect of construction operations. It then sought that sum in court by way of summary judgment. This claim too failed, because Severfield could not establish that the claim now made was, to all intents and purposes, the interim payment claim 15. Severfield needed to be able to establish that proposition, in order to take advantage of the absence of a valid payment notice or pay less notice from Duro Felguera.

[14] *Severfield (UK) Ltd v Duro Felguera UK Ltd* 163 Con.L.R. 235; [2015] EWHC 3352 (TCC).

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The £1,445,495.78 was not the notified sum nor the sum stated to be due in interim application 15. There was no reference to the £1,445,495.78 in the notice and it was therefore not a payment notice in respect of that claim. It was not a valid notice in respect of that claim, even if the notice included spreadsheets with line items which amounted to the £1,445,495.78 if one disregarded the other line items. Such a claim was not at all clear from either the notice or the accompanying spreadsheet. In any case, the judge was not convinced the claim was identifiable in that way from the original notice and spreadsheet; it was arguable the claim was further revised; it was described by Severfield as revised.

The judgment is clearly correct on all these matters.

Coulson J (as he then was) concluded his judgment with the following policy recommendations for parliament:

> "I should add this. All of the difficulties here, in both the old and the new proceedings, can be traced back to s.105 of the 1996 Act and the legislature's desire to exclude certain industries from adjudication. A review of the debates in *Hansard* reveal that parliament was aware of the difficulties that these exemptions would cause, but justified them on the grounds that (i) adjudication was seen as some form of 'punishment' for the construction industry from which (ii) the power industry and some other industries should be exempt, because 'they had managed their affairs reasonably well in the past'.
>
> I consider that both of these underlying assumptions were, and remain, misconceived. Adjudication, both as proposed in the Bill and as something that has now been in operation for almost 20 years, is an effective and efficient dispute resolution process. Far from being a 'punishment', it has been generally regarded as a blessing by the construction industry. Furthermore, it is a blessing which need then – and certainly needs now – to be conferred on all those industries (such as power generation) which are currently exempt. As this case demonstrates only too clearly, they too would benefit from the clarity and certainty brought by the 1996 Act."[15]

Conclusions

Where there is a hybrid contract, there is the possibility that, while a dispute as to the construction operations may be referred to adjudication, a dispute as to the non-construction operations may not be. In that case, a party seeking to refer a dispute to adjudication will need to take care that the dispute it is referring is in respect of construction operations. An adjudicator should also take care in these cases to ensure that the adjudicator's decision is

[15] *Severfield*, above, at [62-63].

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in respect of construction operations only. Otherwise the responding party may be able to challenge the validity of the decision. If an adjudicator's decision is in respect of both construction operations and non-construction operations, it will depend on the facts of the particular case whether the decision may be severed so that the valid part stands and the invalid part is discarded.

These complications may be avoided if the parties are alive to them at the time of making their contract. A simple solution is to make contractual provision for adjudication that mirrors the requirements of the HGCR Act. This will enable an adjudication which will be valid in respect of both construction operations and non-construction operations.

Where there is a hybrid contract, there is the possibility that the payment provisions of the HGCR Act will apply only to the construction operations and not to the non-construction operations. This can be a risk area if the parties were not alive to the issue at the time of making their contract. For example, the contractual payment provisions may not comply with the provisions of the HGCR Act. In such a case, the provisions of the Scheme will apply, but only in respect of construction operations, not non-construction operations. Thus there can be two different payment mechanisms in operation, although this may not originally have been intended. Or it may be that there should be two different payment mechanisms in operation, but the parties have not in fact operated the two different payment mechanisms correctly.

The potential for confusion with two different payment mechanisms may be avoided by contractual agreement to a payment regime that applies to both construction operations and non-construction operations and that is compliant with the HGCR Act requirements as to payment provision.