Fenwick Elliott

The construction & energy law specialists

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Welcome to the July edition of ***Insight***, Fenwick Elliott's newsletter which provides practical information on topical issues affecting the building, engineering and energy sectors.

In this issue find out about Project Bank Accounts.

Insight

Project Bank Accounts - the way forward?

Since their launch five years ago, Project Bank Accounts have been used on public sector contracts worth £2.5bn. In line with the Government Construction Strategy, the Government has confirmed Project Bank Accounts will be used on public sector projects "*unless there are compelling reasons not to do so*". Project Bank Accounts are therefore quickly becoming standard in public sector procurement and their use might become just as widespread in private sector procurement in the not too distant future.

This thirteenth issue of *Insight* considers (i) how Project Bank Accounts work in practice; (ii) their advantages and disadvantages; and (iii) practical advice for newcomers to Project Bank Accounts.

What is a Project Bank Account?

Project Bank Accounts (PBAs) are ring-fenced bank accounts whose sole purpose is to act as a channel for payment on construction projects to ensure that contractors, key subcontractors and key members of the supply chain are paid on the contractually agreed dates.

The employer maintains adequate funds in the account to cover work in progress and other project commitments. Payments are made directly from the account to the contractor, key subcontractors and key suppliers in accordance with the payment arrangements agreed by those members of the project team who are party to the PBA.

How does a PBA work in practice?

In the usual course of events, the PBA is set up by the employer either in the employer's own name (in which case the employer might give the contractor's representatives authority to act under a bank mandate) or in the employer's and contractor's joint names on trust for the key subcontractors and key members of the supply chain. If the latter approach is taken, the key subcontractors and key members of the supply chain would be party to the trust deed.

PBAs differ from the usual payment mechanism in that instead of paying the certified sum to the contractor, the employer funds the PBA one or two months in advance (and therefore in advance of the progress of the works). To ensure the balance remains positive, the employer will usually have a detailed and frequently updated payment schedule which sets out the envisaged construction costs in each month of the project.

Each month, the contractor, subcontractors and consultants submit their payment applications in the usual way. Interim certificates are issued and agreement is reached as to the entitlement of the project team to a proportion of the sum certified. The account holders then instruct the bank to remit payment of the certified sum and payment from the PBA discharges the sums due under the main and subcontracts.

If the employer's payment needs to be reduced, due to the contractor's default for example, then the contractor may be required to make a top-up payment into the account so that subcontractors and suppliers can be paid. Equally, the employer (or if there is a shortfall or the employer fails to make payment, the contractor) may be required to ensure the balance remains at an agreed minimum level.

Each member of the PBA has direct signing rights over the PBA and as soon as a payment has been certified, each party can withdraw the certified sum to which it is entitled instead of having to wait to receive payment from the employer or from those higher up the contractual chain.

Advantages

The advantages that accrue from the use of PBAs are ultimately financial and this is of particular note in the current climate.

Security of payment

Provided the PBA is properly set up, the principal advantage of a PBA as far as contractors and the rest of the project team are concerned is that in the event of an insolvency in the contractual chain, payments can still be made to members of the project team.

The developer also benefits since the risk of an employer having to pay suppliers and subcontractors for the same work twice in circumstances where the contractor fails to remit payment and then becomes insolvent falls away.

Speed of payment

PBAs should speed up payment and reduce payment abuse, particularly for those lower down the supply chain for whom late payment can have a significant impact against what are often very tight margins. The reason for this is that payment does not have to flow down the contractual chain: instead, those members of the project team who are party to the PBA are paid directly from the PBA.

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Cash flow management
Management of cash flow is transparent under a PBA in that the contractor and supply chain benefit from having the certainty that money has been paid into the PBA in advance of the date on which payment falls due.

One of those to benefit from PBAs is the smaller contractor further down the supply chain who has to tolerate compounded payment periods. Paying parties at the lower end of the contractual chain often find themselves having to gradually extend their own payment periods as onward payment is only made upon receipt of funds from those higher up the chain. This makes things very difficult for smaller subcontractors and suppliers who effectively have to trade on credit

Cost savings
The Government estimates that if they are properly implemented across the board, PBAs can deliver up to 2.5% in savings in the cost of construction projects.

These cost savings arise by virtue of the fact that (i) supply chain members do not have to chase for payment, thus reducing administration charges, and (ii) the need to finance lengthy credit periods reflective of the long payment chains from employer to contractor, from contractor to subcontractor and from subcontractor to supplier, is eliminated.

Disadvantages

Fortunately for contractors, the disadvantages of PBAs only affect employers and funders.

Set-up costs
PBAs can cost money to establish and run, and the negotiations that lead to the setting up of a PBA can be lengthy. Unless the groundwork is put in in the early stages of a project, the administrative burdens of a PBA as well as the training costs for an unfamiliar project team may be disproportionately high. PBAs are therefore most suitable for larger-scale projects or related schemes of work.

Loss of control from employer / funder's perspective
A PBA can also reduce the control a bank or employer has over a project: if money is tied up in a PBA it may not be able to be used for other purposes.

In terms of the payment mechanism, if an employer needs to make a deduction for defective work, it will need to ensure that the PBA arrangements allow it to act upon such a deduction. If a deduction is justified by virtue of a main contractor error, then the main contractor may need to pay more money into the PBA to enable subcontractors and suppliers to be paid.

Payment disputes will remain
Although the use of a PBA can provide greater certainty around payment, it does not guarantee that correct payments will be made, nor will it eliminate payment disputes. The usual procedures for making payment still need to be adhered to, queries about a contractor's account still need to be answered and the employer can still withhold payment or set off sums that might otherwise be due (provided of course that the PBA arrangements allow the employer to do so).

Practical advice for newcomers to Project Bank Accounts

To receive the above benefits that PBAs can bring, in particular security for payment from which the other benefits then flow, the PBA must create a trust in favour of the contractor in order to be effective.

If a trust exists and the employer becomes insolvent, it is generally understood that the funds in a properly constituted PBA will not fall to be included with the employer's other assets and they should therefore be protected from the hands of creditors. If there is no trust in favour of the contractor, in the event of insolvency, the contractor will probably rank as an unsecured creditor and will receive little if anything by way of a return on its debt.

In practice, identifying whether a trust exists in relation to the balance of a PBA of an insolvent company can be difficult. If, for example, the insolvent company mixes its own funds with trust funds, it can cause the trust to fail. It is therefore of paramount importance that the trust mechanism is approved by a trust specialist to ensure it will be effective upon any insolvency.

Also of importance is to double check that the terms of the PBA documentation dovetail with the payment provisions in the building contract. The provisions in the building contract must also make clear how the PBA is to be set up and funded, and how payments are to be made following on from the certification process. If this is not the case, there is a risk the payment mechanism may break down, in which case the speed and security of payment, cash flow management and cost–savings benefits mentioned above may fall away.

Conclusion

The advantages of PBAs almost certainly outweigh any disadvantages, and whilst PBAs are heavily favoured by the majority of industry commentators, their use is not yet commonplace. This lack of use is most likely reflective of the reluctance of members of the construction industry to move into new territory at a time where market conditions are uncertain and Building Information Modelling is also on the horizon.

The widespread use of PBAs may well revolutionise the way the construction supply chain gets paid and it will therefore be interesting to follow the progress of PBAs as the construction sector begins to recover.

Should you wish to receive further information in relation to this briefing note or the source material referred to, then please contact Lisa Kingston.
lkingston@fenwickelliott.com.
Tel +44 (0) 207 421 1986

Fenwick Elliott LLP
Aldwych House
71-91 Aldwych
London WC2B 4HN
www.fenwickelliott.com