

Insights

THE CONSTRUCTION ACT AND MODULAR CONSTRUCTION PROJECTS

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SUMMARY

Since we previously blogged about modular construction, it has continued to develop in popularity. The more we see of modular, the more it becomes clear that it is a very different beast to “traditional” construction projects, demanding an evolution in procurement routes and contract content.

The problems with shoehorning a modular project into the “traditional” contract mould were aptly demonstrated by the recent case of *Bennett (Construction) Ltd v CIMC MBS Ltd (formerly Verbus Systems Ltd)*. Fellow blogger, Jonathan Cope, wrote an *excellent blog looking at this case in detail*. In this blog I want to focus on what this case tells us about the new approach that modular demands.

Let’s start with a quick recap of the case.

BENNETT V VERBUS – IN A NUTSHELL

The case concerned the payment provisions within an amended *JCT contract* for the construction of a new hotel. Bennett was the main contractor and Verbus was sub-contracted to design, supply and install prefabricated modular bedroom units.

The JCT interim payment provisions were heavily amended to include five milestone payments, three of which required sign off in order for the milestone to be achieved. The parties disagreed over what was meant by “sign-off”.

At first instance, milestones 2 and 3 were found not to comply with the *Construction Act*. The offending provisions were disapplied and replaced by the *provisions from the Scheme for Construction Contracts*. The court held that Verbus was entitled to payment calculated by reference to the value of the work carried out, rather than the agreed percentage of the contract value for the relevant milestone.

On appeal, Coulson LJ held that the milestone payments were compliant with the Act. The basis of his decision was that “sign-off” meant the date on which the units were complete, assessed objectively rather than subjectively. As such, it did not mean that payment was not due until the date actual sign-off occurred because “actual” physical sign-off was not required.

SOME THOUGHTS

CONSTRUCTION ACT – SHOULD IT APPLY TO MODULAR CONTRACTS?

Yes.

In *Bennett* it was taken as read that the Construction Act applied to the contract. But when you break down what a modular contract is trying to do: off-site manufacture, delivery and then installation versus a “traditional” contract’s focus on build, the question arises: should the Act in fact apply? Is it more of a hindrance than a help?

Arguably, a commercial payment model (for example, one or more lump sum payments including on delivery to site) would be more appropriate for the manufacturing stage of a modular project. And to be fair, the *Construction Act does not apply to the off-site element of manufacture (section 105(2)(d))*. It is only when “installation” is introduced that the Act bites. In other words, if the contract includes both manufacture and installation, then the Act will apply.

But splitting out the off-site manufacture and on-site installation elements into two separate contracts is unlikely to work from a practical perspective. The contracts need to be viewed as interlocking pieces of the entire project. Inconsistent provisions (particularly around disputes) could play havoc with contract administration, management and dispute resolution.

DO MILESTONE PAYMENTS REALLY WORK ON MODULAR PROJECTS?

To an extent.

The Construction Act provides that payment must be made in instalments during the course of a construction contract.

As discussed above, the nature of modular construction doesn’t lend itself to such an approach particularly well. The parties often negotiate milestone payments to balance the competing demands of the modular supplier’s cash flow and the main contractor/employer’s wish to link payments to value being provided. In essence, this is because modular construction is not “construction” as the industry understands it, but more akin to the provision of a particularly complex class of “off-site materials”. As such the concerns around the treatment of, security over and payment for off-site materials apply.

These concerns are greatly magnified in modular, since the value in a construction contract which relates to the design, manufacture and installation of modular products can be skewed in favour of

the off-site design and manufacture by the modular supplier rather than the value of the works being performed on site. We often see the modular element of the works accounting for perhaps 60-75% of the overall contract value, with the on-site works, including installation, “zip-up” and so on forming the remainder. So the main contractor may find itself in a situation where it is taking risk on the performance of a modular supplier whose package is significantly greater in value than the remainder of the works.

In addition, given the bespoke nature of the modular offering, employers and funders are concerned to ensure there is realisable long-term value in the product that has been delivered. It is notable in the *Bennett* case that the developer, Key Homes, went into liquidation and the modular product (the subject of the case) was eventually scrapped. If the product doesn’t work and the contract is terminated, then it is likely that a new solution will need to be found, with corresponding project delays and increased costs being suffered by the developer.

While milestone payments may seem to be the answer to the parties’ competing demands in modular contracts, there remain practical issues with them beyond the need to ensure that they are clearly defined and drafted to avoid disputes.

Where a main contractor is wrapping a modular sub-contractor or the modular supplier is the main contractor itself, further complexities arise that will need to be considered. In such circumstances two different payment regimes may be needed; for example, a mix of milestone and progress payments. Standard form contracts tend to work with an either/or approach to payment and don’t typically contemplate that both regimes may be needed. On a practical level, employer’s agents aren’t generally familiar with operating two such regimes side by side, so the scope for error may be greater than under a “traditional” set-up.

HOW DOES A MAIN CONTRACTOR PROTECT ITSELF WITHIN THE CONTRACT?

There remains a fundamental difference in risk profile for a main contractor being asked to contract with a modular supplier as a sub-contractor compared to a “traditional” sub-contractor. To the extent that there is any disconnect, a main contractor may find itself bearing significantly increased or different risks to those it is familiar with.

The modular supplier is off-site. It is therefore, other than contractually, more remote from, and outside the control of, the main contractor than the latter is used to. This, practically, increases the main contractor’s risk of non-delivery and cannot easily be mitigated by levels of *performance security, liquidated and ascertained damages* or other methods.

While typical contractual requirements for performance security, such as *vesting certificates, retentions* or caps on payment for off-site materials can provide some protection for a main contractor, practical risks remain as a result of adopting modular construction. All these tools will have consequences for the price quoted by the modular contractor. As such they reduce the

potential cost savings of modular construction, even though other benefits remain (such as shorter delivery times and reduced time on site).

SOMETHING NEW?

Contract forms, including the payment terms, haven't kept up with the change of mindset that modular requires. So far, the approach has been to retrofit existing standard forms to try to make them work within a very different context. There has been limited appetite to draft new, bespoke forms, due to the expense involved and also because of the wide variety of development structures within which modular construction is starting to operate. Where is the value in drafting a bespoke contract if it cannot be rolled out on future deals and standardised?

Although completely understandable, this approach seems less than ideal, since those standard forms were not prepared with the specific context of off-site construction or the nature of the modular product in mind. Traditional construction standard forms don't take into account what happens in the factory, the need for enhanced security, a more complex inspection regime and, above all, different and evolved payment mechanics.

GOING FORWARD

Modular construction is different from traditional building. Contracting parties and their advisers need to work together to develop new procurement strategies that reflect the realities of how it works and that can help to avoid results similar to those experienced in the *Bennett* case.

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