

Insights

SECURITY OF PAYMENT IN HONG KONG – PILOT PROGRAMME FOR PUBLIC WORKS CONTRACTS

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As the old saying holds, cash-flow is the life blood of the construction industry.

In 2021, Hong Kong looks set to join Singapore, Australia and other jurisdictions in implementing a Security of Payment regime to regulate payment practices and provide a system to protect cash flow in the construction industry. As a first step, the Hong Kong Development Bureau has released consultation drafts of a Technical Circular annexing draft Security of Payment provisions for inclusion in public works contracts and sub-contracts.

Titled “*Implementation of the Spirit of Security of Payment Legislation in Public Works Contract*”, the draft Circular establishes a contractual regime to apply to public works contracts and sub-contracts for the timely processing of contract payments and the expedited interim resolution of payment disputes by adjudication. According to the Circular, the contractual regime is scheduled for implementation in public works contracts which go to tender during or after the second half of 2021. It appears that for the purposes of the Circular, public works contracts are limited to those contracts issued by Hong Kong Government and does not include contracts issued by statutory bodies or corporations.

The Circular is intended to pave the way for the subsequent enactment of Security of Payment legislation in Hong Kong. Based on current information, the final legislation is likely to affect all public works construction contracts (including contracts issued by specified statutory/public bodies and corporations) for procurement of construction work or related goods and services. It is also likely that that the legislation will apply to private sector construction contracts with a value exceeding HK\$5 million (for works contracts) or HK\$0.5 million (for supply of goods and services, including professional services).

The initial limited deployment of Security of Payment in Hong Kong on a contractual basis, restricted to public sector activities, should provide the Hong Kong Government and the industry with an opportunity to test the regime and to identify snags or ambiguities in parallel with the development of the Security of Payment legislation.

The Security of Payment Framework

The Circular annexes the “*Security of Payment Framework*” which has been prepared by the Development Bureau to guide the drafting of the Security of Payment bill. The Framework is a policy document and does not appear to have any stand-alone legal effect.

To comply with the Framework, construction contracts to which the Security of Payment legislation applies must reflect the following mandatory requirements:

- Payment response to be made by the paying party within 30 days of claim submission. Payment of any amount admitted in the payment response to occur within 60 days of the payment claim.
- Conditional payment provisions (such as “pay when paid”) to be rendered ineffective and unenforceable.
- Payment disputes to be referable to adjudication, with the adjudicator to issue his or her decision within 55 working days of appointment. The adjudicator’s decision will be binding on an interim basis.
- The claimant to be entitled to suspend or reduce the rate of progress of its work, if the admitted or adjudicated amount is not paid when due.

The Security of Payment Provisions

The Circular also annexes “*Security of Payment Provisions*” which set out contractual provisions for inclusion in public works contracts. The Security of Payment Provisions, which will be incorporated into contracts by special condition, are consistent with the mandatory requirements stated in the Framework. The provisions also set out additional detail on matters such as the information requirements for payment claims and responses, and the nomination and appointment of adjudicators.

There is some ambiguity as to the extent to which the Security of Payment Provisions may be varied. The Circular expressly states that parties are to retain autonomy to agree the terms of their contract in respect of contract payments and dispute resolution mechanisms, provided that the four mandatory requirements are retained. This could be interpreted to mean that the Security of Payment Provisions may be varied on a project by project basis, subject always to complying with the mandatory requirements. However, the remainder of the Circular suggests that the Security of Payment Provisions are to be incorporated without amendment. In such case, the parties’ autonomy will likely be limited to deciding matters not addressed in the Security of Payment Provisions or for which the Security of Payment Provisions expressly incorporate some degree of flexibility – such as the allowance for payment periods which are shorter than the 60-day period mandated by the Security of Payment Framework. In any case, it is to be hoped that this ambiguity will be rectified before the Circular goes into effect.

Mandatory provisions for inclusion in sub-contracts connected with public works contracts

The Circular also annexes "*Mandatory Sub-Contract Provisions*" for incorporation into all sub-contracts of any tier engaged under a relevant public works contract. The Mandatory Sub-Contract Provisions largely correspond to the Security of Payment Provisions, with some notable differences which are described below.

Firstly, the Mandatory Sub-Contract Provisions expressly provide that any conditional payment provision (such as "pay when paid") included elsewhere in the sub-contract will be unenforceable and of no effect. This provision is not reflected in the Security of Payment Provisions, presumably on the basis that HK Government can ensure that no such provisions are included in the main contract.

In addition, the Mandatory Sub-Contract Provisions entitle sub-contractors of any tier to require the employer to make direct payment of any amount which has been adjudicated as due from the main contractor (or a higher-tier sub-contractor, as relevant) but which remains unpaid. The mechanism is complex, but in summary, requires the sub-contractor to make a written declaration that all or part of the adjudicated amount is due and remains unpaid, while the main contractor is given an opportunity to provide documentary proof showing the contrary. Where a direct payment is made, the employer will be entitled to make a corresponding deduction from amounts due from the employer to the main contractor. Importantly, if the main contractor can demonstrate the sub-contractor was not paid due to the insolvency of a higher-tier sub-contractor, the employer will not make a direct payment.

The effect of the direct payment provisions on the main contractor is onerous. To avoid liability to the employer, the main contractor needs to police all tiers of its sub-contracting chain and ensure that payments are made as and when due.

The Security of Payment Provisions impose an express obligation on main contractors to take all reasonable steps to ensure that the Mandatory Subcontract Conditions are included in all lower tiers of sub-contracts. The Sub-Contract Mandatory Provisions impose similar obligations on each sub-contractor. In addition, the Circular states that the main contractors' compliance with this requirement will be monitored and failures to comply may result in a downgrade of that contractor's performance. Any such downgrade will in turn likely impact upon that contractor's ability to win future public works contracts.

It is unclear what, if any, other material consequences might flow from a failure on the part of a main contractor or a higher-tier sub-contractor to take reasonable steps to ensure that the Mandatory Sub-Contract Provisions are incorporated in a lower-tier sub-contract. Certainly, any such failure would be a breach of the higher-tier agreement, entitling the other party to that higher-tier agreement (that is, the employer, the main contractor or an upper-tier sub-contractors, as relevant) to damages. However, the affected lower-tier sub-contractor (who will be the party most

disadvantaged by the absence of the Mandatory Sub-Contract Provisions) will not have any contractual recourse. This is because the direct payment mechanism intended to protect the lower tier sub-contractor will likely have been omitted from the relevant sub-contract. Relatedly, it will probably be difficult to quantify what damages flow from any such breach, as the other party to the higher-tier agreement will not have suffered any obvious loss. These issues arise because of the contractual basis of the Security of Payment regime enacted by the Circular. The Security of Payment legislation, once enacted, will provide more expansive protections allowing parties to access payment adjudication notwithstanding the particular terms of their contracts. Such legislation will also likely impose material penalties for parties which contravene its provisions.

Adjudicator's powers to make determinations on time-related costs

A significant bone of contention for some time has been the extent to which EOTs and the related costs should be included within any Security of Payment regime in Hong Kong. How has this been addressed in the draft Circular?

The Circular says that the majority of the industry stakeholders support a proposal by which the adjudicator would be entitled to make binding determinations as to time-related costs forming part of a payment dispute. In order to make that determination, the adjudicator would also be empowered to make non-binding determinations as to the extension of time due for relevant delays. Despite the adjudicator's EOT determination being non-binding, the claimant would still be entitled to interim relief from liquidated damages levied in respect of any period covered by an adjudicator's EOT determination.

The above regime maintains a clear division between issues of money and time – with the adjudicator enabled to make binding determinations on matters of money only. The relief from liquidated damages is consistent with this position as the contractor's financial position is protected, without affecting any other matter consequential to a contractor's failure to comply with its completion obligations (such as termination rights). This outcome is also consistent with the expressed goals of the Circular, being the timely processing of contract payments and the expedited interim resolution of payment disputes.

However, the above principles are only partially reflected in the Security of Payment Provisions. The adjudicator is expressly empowered to make binding interim determinations on time-related costs. The adjudicator is also entitled to determine consequential or ancillary matters which are necessary to resolve the payment dispute, which likely includes the extent of any relevant delay giving rise to time-related costs. However, the Security of Payment Provisions do not specifically address EOTs or the treatment of liquidated damages – it is not clear if or how these additional elements of the Security of Payment Framework will be implemented.

Getting ready

The introduction of a Security of Payment regime will be one of the most significant reforms to the Hong Kong construction industry in decades. Construction industry participants will need to get up to speed on the legal, logistical and financial implications of the Security of Payment regime quickly and efficiently. Decisions on resourcing, claim management strategy and risk mitigation are only some of the important issues affecting your business which will need to be thoughtfully addressed. Relatedly, the implementation of Security of Payment in Hong Kong will unavoidably have its teething problems. Uncertainties, ambiguities and unexpected issues will be commonplace and require careful management.

BCLP has extensive experience dealing with Security of Payment issues in Singapore, Australia and the UK, including in the early days of each regime's implementation. We have seen, first-hand, the administrative load and increased financial risk which can come with a far-reaching reform to the payment processes of an entire industry.

Editor's note: The circular has been issued on 5 October 2021, with changes and clarifications to the draft discussed in this article. For a discussion of the [circular as issued by the Development Bureau](#), please see our articles "[Security of payment circular issued by the Development Bureau of Hong Kong – to take effect from 31 December 2021](#)" and "[The new security of payment regime in Hong Kong – key issues to consider before its implementation](#)".

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