PROJECT
BANK ACCOUNTS

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Introduction[1]

A project bank account (PBA) is a term used to describe a payment mechanism which is grafted on to a standard form, under which both contractor and subcontractors are paid at the same time.[2] Since its launch five years ago, the PBA has been used on public sector contracts worth £2.5bn, expected to increase to £4bn by 2014.[3] It has been agreed within Government that the PBA should be used in future 'unless there are compelling reasons not to do so'.[4] According to the Government model, this requires a trust deed, a bank mandate, and appropriate amendments to main and subcontracts.

Much has been written on the economic and commercial aspects of the PBA. In this paper I offer a legal analysis in three parts:

- In Part 1, I outline the PBA, describing how it is documented and administered
- In Part 2 I move on to the legal concepts engaged by a PBA, referring where relevant to case law in related areas such as direct payment and construction trusts
- Finally, Part 3 explores the challenges which an insolvency practitioner appointed to the contractor might make to a PBA.

1 Documenting and administering the PBA

Documentation

The Institution of Civil Engineers (ICE) has produced a very brief trust deed for use with NEC3,[5] but in practice it is common for the parties to use the precedent drafted for the Office of Government Commerce.[6] This also forms

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1 I should like to thank Janet Hoskin, partner in Pinsent Masons LLP, and Chris Snodin, partner in Harold Benjamin, for commenting on an earlier draft of this paper.

2 The Highways Agency uses a PBA to pay tiers 1-3, ie to sub-subcontract level: www.highways.gov.uk/business/33974.aspx.

3 Cabinet Office, Project Bank Accounts briefing document (10 February 2012), available at www.cabinetoffice.gov.uk.

4 Office of Government Commerce, *Making fair payment in construction a requirement in central government contracts* (Information Note 2/2010) states: '… the Construction Clients Board has agreed that Central Government Departments, their agencies and Non-Departmental Public Bodies, move to a position where Project Bank Accounts are adopted in line with the guidance unless there are compelling reasons not to do so'.

5 NEC, 'OGC fair payment practices for use with NEC Contracts' (June 2008), downloadable from www.neccontract.com, page 6.

6 Office of Government Commerce, *Guide to Best 'Fair Payment' Practices* (2007), Appendix A. The OGC was replaced in the Cabinet Office by the Efficiency Reform

the basis of the PBA offered by Barclays Bank and the PBA documentation published by the JCT.[7] I describe its terms below.

No particular wording for the mandate is suggested by the OGC or the standard form bodies. Barclays use their standard mandate for a joint account between companies under which one company opens the account but either can give instructions relating to its administration. The mandate names individuals authorised to act on their behalf, eg in operating an online banking facility. The project manager may decide that this is not sufficient and that either the bank's mandate should be amended or a separate letter of instructions agreed with the bank. The letter could make it clear for example that the account is a trust account and cannot become overdrawn or be subject to set-off in respect of any claim which the bank may have against a project participant.

As far as contract amendments are concerned, there is a new cl Z3 to go with the NEC form[8] and brief enabling provisions for use with JCT forms.[9] There is a standard form deed of adherence enabling new subcontractors to join the PBA.

The PBA in practice

The payment mechanism consists of a bank account whose sole purpose is to act as a channel for payment on the project. Under the OGC and JCT versions, the account is opened in the names of the employer and the contractor. Under NEC3, the contractor opens the account. There is no reason why the employer could not open the account and give representatives of the contractor authority to act under the mandate. The PBA is subject to the approval of the project manager, to whom all communications with the bank must be copied.

The basic concept of a project bank account is that, instead of paying a certified sum to the contractor, the employer makes a payment into the account. The money standing to the credit of the account is held in trust for 'named suppliers' who are made parties to the trust deed or are identifiable from it. Both employer and contractor agree a payment authorisation showing how the amount credited to the account is apportioned between the contractor and the named suppliers. The account holder(s) then instruct the bank to disburse the sum in accordance with the authorisation. Everyone agrees to treat payment from the account as discharging the sums due under main and subcontracts. In this way, a debt owed to one person is discharged by payment to many. Prompt payment is assured as the contractor is paid from the account at the same time as the named suppliers.

Group in 2011 and its website was closed down. The guide is available on other sites, eg www.hvca.org.uk.

7 Joint Contracts Tribunal, *Project Bank Account Documentation* (2010).

8 NEC, 'OGC fair payment practices for use with NEC Contracts' (June 2008): see note 5.

9 JCT, *Project Bank Account Documentation 2011 (PBA 2011)*, obtainable from www.jctltd.co.uk.

It is left to the parties to fit the PBA into the payment scheme set out in cl.5 of NEC3, as amended where the 1996 Act applies by cl Y(UK)2. The chart given in Appendix C of the OGC Guide headed ‘Typical payment process’ omits all reference to set-off and the 1996 Act. This presumably reflects cl 50.2 of NEC3, which apparently enables cross-claims to be taken into account in the valuation process before the certificate is issued (see later). If we add in the statutory requirements, the order of events runs as follows:

1. Before the assessment date, the contractor serves an application for payment on the project manager showing sums claimed for itself and for each of the named suppliers.
2. The project manager certifies payment to the contractor within seven days.
3. There are then seven days for service of withholding or ‘pay less’ notices under the 1996 Act.
4. The employer pays into the account the amount due to be paid to the contractor. This is presumably the certified sum less any sums withheld.
5. The contractor then tops up the PBA to make good ‘any amount not paid by the employer’, paying in ‘any amount required to make payment in full to Named Suppliers’.
6. The contractor prepares the authorisation to the bank, detailing who is to be paid what from the account. This is signed by the contractor, countersigned by the employer and forwarded to the bank.
7. Payment is made from the account as soon as practicable thereafter, at any rate by the final date for payment, which is 14 days after the certificate.

2 What is the conceptual basis of a PBA?

Contract and trust

As far as payment is concerned, a construction contract creates a debtor-creditor relationship. This can be illustrated by the Scottish case of *Veitchi v Crowley Russell*, in which the main contract provided:

> ‘The architect shall state in each certificate issued by him the amounts included in respect of the work of the various subcontractors, and the principal contractor shall … pay over to each subcontractor the sum due to such subcontractor in respect of work carried out by him and covered by the certificate.’[10]

It was held that the obligation to ‘pay over’ was part of the machinery of payment and did not create a trust in favour of the subcontractors. In law, money received from the employer is not the source from which subcontractors are paid. Subcontractors are only entitled to an amount equal

10 *Veitchi Company Ltd v Crowley Russell & Company Ltd* [1972] SC 225 (Ct of Session).

to the payment received from the employer, not the payment itself. It follows that unless they have proprietary rights in the sum due to the contractor under a trust or by way of equitable assignment, they will be unsecured creditors in the contractor's liquidation.

The intention of a PBA is to reinforce the debtor-creditor relationship under a subcontract (and even further down the chain) by providing a source from which subcontractors are to be paid. Unusually, the trust is to facilitate payment: on one view, it lasts only as long as the bank needs to process the payment in and the payments out. Its sole purpose is to reinforce the contractor's personal obligation by creating new property to serve as the subject matter of a trust.

However the devil is in the detail. Problems can occur if the terms of the contract are unclear to start with, or use language or concepts which differ from the terms of the trust, or where the contract fails to provide processes necessary for the administration of the trust. Perhaps the first issue to consider in this context concerns the treatment of the certified sum.

What happens to the certified sum?

A certified sum is a debt and a debt is both a personal right at common law and disposable property in equity. The normal position is that the certified sum will form part of the contractor's property available for distribution to creditors on its liquidation. Remedies available to administrators and liquidators under insolvency law are predicated on the assumption that the certified sum is the contractor's property. It is important therefore to be aware of the effect of a PBA on the ownership of the certified sum.

Clause 2.2 of the trust deed provides:

> 'The Client undertakes to pay all monies due to the Contractor and/or the Sub-Contractors under the Contract and the Sub-Contracts into the Bank Account as and when such monies become due for payment in accordance with the terms of the Contract.'[11]

Leaving to one side the question when sums become due in this context, the reference to 'monies due' can refer only to the certified sum. Clause 3.2.1 refers to payment of monies due under the main contract. The deed also makes it clear however that neither the employer (cl 2.6) nor the contractor or the subcontractors (cl 2.3) have any interest in the account, except as beneficiaries of the trust.

It seems to follow that the payment in is intended to create trust property, but not necessarily to discharge the certified sum. The direct payment arrangement runs parallel to the contract. The deed is silent on the effect on the contract of payments in and out of the trust account. For that we have to turn to cl Z3.14:

11 The JCT version, note 7, omits the references to subcontractors in this clause.

> ‘Payments made from the Project Bank Account are treated as payments from the employer to the contractor in accordance with this contract or from the contractor or subcontractor to named suppliers in accordance with their contracts as applicable.’

It is not clear whether the phrase ‘payments from the employer [E] to the contractor [C] in accordance with this contract’ refers only to ‘the balance of the certified payment’ in cl Z3.10, eg the contractor’s fee, or covers the whole certified sum. It appears to mean that payment to SCs (and payment of the element due to C) is to be ‘treated as’ payment by E of the certified sum to C, and payment by C of sums due under subcontracts. In substance, the certified sum is paid direct to the SCs and is then deemed to have been paid to C.[12] The contract does not use the JCT concept of direct payment followed by set-off against sums due to C or say that the direct payments are made from moneys owing to C.

If this is the correct construction, the certified sum continues to be owed until all payments are made from the account.[13] The debt constituted by the certificate remains C’s property until that has occurred. Implicit in the scheme is C’s agreement not to enforce payment under the contract while the trust deed is in operation.

Under the JCT scheme, payment into the account discharges the debt:

> ‘X.5: The Contractor acknowledges that payment into the PBA shall discharge the Employer’s obligation to make payment under the Building Contract to the extent of that payment.’

In its place, the contractor becomes a beneficiary of the account for its element of the certified sum. The JCT approach is efficient as the payment in has the effect of instantaneously discharging the debt due to the contractor and constituting the trust fund. This is very condensed and it is tempting to read a narrative into it along the following lines:

1. The employer discharges a debt due to the contractor;
2. The proceeds of the debt become a fund in the form of a debt owed to the contractor by the bank; and
3. The contractor declares a trust over the fund for itself and the named suppliers.

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12 A term that a direct payment should ‘be regarded as’ payment under the principal contract was enforced in *Braspetro Oil Services v FPSO Construction* [2005] EWHC 1316 (Comm), but it appears that the contractor was not formally insolvent. At any rate, the court was proceeding on the basis that it was solvent and that the court did not therefore have to consider the *pari passu* rule (see Part 3 of this paper).

13 In *Re Niagara Mechanical Services International Ltd* [2001] BCC 393 (Ch) Ferris J stated at para [33]: ‘I see no reason why a debtor should not make a payment to his creditor and impress the payment with a requirement that it be applied not in satisfaction of the indebtedness but for a particular purpose.’ Here the payment is not even made to the ‘creditor’ and it would seem to follow that express provision would be needed to discharge the certified sum on payment into the account.

On this analysis there would be a significant difference between the standard forms of PBA. Under NEC3, the employer funds the trust account with its own money; in the JCT version, the account is funded with money belonging to the contractor, namely the proceeds of the debt created by the certified sum. The consequences of this analysis are twofold. First, it could affect the operation of a resulting trust in the event that the express trust fails. The resulting trust would be in favour of the person who funded the account. Second, it might affect the accounting treatment of a PBA.

Against this approach, it might be said that in law all that has happened is that there has been a debit on the employer's account at its bank and a credit in the project bank account. It does not necessarily follow from the contractor's agreement to be discharged that it acquired any property right in the credit balance, even for an instant, apart from its right to payment as a beneficiary under the trust. If this is correct, the trust deed treats the debt differently from its proceeds. Both the certified sum and the credit balance are rights to payment: one owed by the employer to the contractor, the other owed by the bank to the trustees. This may be the better analysis; otherwise the express discharge would have been unnecessary.

What happens if the account is not funded?

The nature of a PBA can also be tested by asking: what remedies are available should the employer fail to fund the account by the final date for payment? This question is not dealt with in either standard form.[14]

The starting point is the proposition that the PBA is in addition to, rather than substitution for, the parties' contractual rights and remedies relating to payment.[15] In effect, the contractor authorises the employer to pay direct and thereby to discharge liability for payment under both main and subcontracts.[16] A failure to fund the account renders the employer in breach of its undertaking in cl 2.2 of the trust deed set out above. It also means that both employer and contractor are in breach of contract. This gives rise to contractual remedies such as suspension, termination, adjudication, and summary judgment.

By cl 2.2 the employer promises to settle money on trust. It might be construed as a contract to create a trust which the court could, by analogy with the cases on the JCT retention trust, enforce by granting an injunction ordering the employer to fund the account. It is arguable that the promise is made to each named supplier as well as the contractor: they are all parties to the deed; are all intended beneficiaries;[17] the certified sum is measured by the value of

14 This is a significant lacuna. The PBA is intended for use by employers in the private sector as well as by government agencies.

15 See the quotation from *Lovell Construction v Independent Estates*: main text to note 71.

16 See *Crantrave Ltd v Lloyd's Bank Plc* [2000] QB 917 (CA); also *Treasure & Son Ltd v Dawes* [2008] EWHC 2181 (TCC).

17 They could not apply to the court as trust beneficiaries since no trust arises until the account has been funded: *Moriarty v Various Customers of BA Peters* [2008] EWCA Civ 1604, [2010] 1 BCLC 142, para [24]. An alternative analysis is that the PBA takes effect as a declaration by the employer that it holds future property on trust for the named suppliers, value being provided by the terms of the contract. However such an intention

their work; and the clause expressly refers to them. Alternatively they could argue that the employer's promise under the clause is held on trust for them by the contractor.[18]

The PBA trust is unusual in amounting to little more than an alternative method of payment. As such, the injunction would be virtually equivalent to summary judgment. However, it would have a collective and multi-tiered quality, as if judgment had been awarded under main and subcontracts all at once. Provided that it could also include a workable solution to the need for the authorisation, the injunction would be an efficient and just solution. It would seem that an application by one named supplier would be in respect of the whole sum, not just its anticipated fraction.

The question arises whether, by entering into the trust deed, the parties have impliedly agreed not to pursue individual remedies in contract pending an application for an injunction in equity for their benefit as a class. It seems more likely that the contractual remedies are concurrent and remain available but might be stayed if an injunction were granted and complied with. If the employer paid off individual suppliers, the amount ordered by way of injunction would reduce *pro tanto*.

As the intention of a PBA is that money in respect of the subcontract works should not pass through C's hands, if C did sue under the contract, the court might impose conditions on granting summary judgment, such as requiring it to pay the proceeds into court or even into the account.[19] If no conditions are imposed, it is probably the case that the proceeds of the judgment will not be subject to any contractual or equitable obligation, but belong to C absolutely.[20] If C is in financial difficulty, the named suppliers might prefer to seek an injunction against E as it would provide security for payment by C.[21] If there is evidence of the likely dissipation of assets by C they might be able to get a freezing order in respect of the proceeds but such an order would not give them any proprietary interest.

There could be a competition between the administrator suing for payment under the main contract and the named suppliers seeking an injunction under the trust deed. If E were also in administration, the court would probably refuse the injunction.[22] But if the order is sought against a solvent party, and the property in question is that of E rather than C, it is conceivable that an

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appears to be negated by terms which clearly intend the trust to apply only to credit balances which are in existence (cll 2.3 and 3.1.8).

18 See Hugh Beale (general editor), *Chitty on Contracts*, (London, Sweet & Maxwell, 30th edition, 2011), para 18.078.

19 This would achieve the same result as an injunction. Alternatively the contractor might limit its claim to a declaration that the certified sum was due and an order that an equivalent amount be paid into the account.

20 The issue also arises in connection with name-borrowing provisions and the procurement of the benefit of the main contract found in some standard forms of subcontract: see Richard Davis, *Construction Insolvency* (London, Sweet & Maxwell, 4th edition 2011), pages 278-282.

21 This is subject to the law on preference, discussed in Part 3 below.

22 *MacJordan Construction Ltd v Brookmount Erostin Ltd* [1992] BCLC 350, [1994] CLC 581 (CA).

injunction would be granted. The difficulty is that E may not get a good discharge as against C on payment being made out of the account, as discharge after C enters administration could be in breach of the *pari passu* rule (see Part 3 below). In that situation an injunction might be viewed as inequitable. If the main contract terminates following C's insolvency, so will the trust deed, and E's duty to fund the account comes to an end. The right to any further payment in respect of the work done, including subcontract work, would then lie with the contractor in administration.

When and how is the trust constituted?

There are three requirements for the constitution of a trust: an intention to create the trust, property to serve as the subject matter of the trust, and beneficiaries to benefit from the trust property.

Intention

A trust can come into being in two ways: the settlor can declare himself trustee of his property for a third party or the settlor can transfer his property to trustees to hold for another's benefit. Clause 2.3 of the OGC deed provides:

> 'The Parties agree that any monies paid into the Bank Account shall, as from the date on which such monies are paid into the Bank Account, be kept separate and distinct and clearly identifiable and shall be held on trust for each of the Contractor and the Sub-Contractors in the amounts owing to them as set out in the Account Holder's instructions to the Bank for the payment of monies to the Contractor and the Sub-Contractors.'

This is sufficient to show the requisite intention, but it is not immediately clear whose intention we are concerned with. The clause states that 'the Parties' (ie E, C and SCs) agree that moneys standing to the credit of the bank account be held in trust. Clause 3.1.8 provides that 'the Account Holders' (ie E and C) agree that they hold the account on trust in accordance with cl.2.3. There is a similar statement in cl 7.3. Equity looks to substance rather than form. As Arden LJ said recently, 'once a trust is declared and attaches to assets, there are a series of default rules and principles which apply irrespective of the intention of the parties setting up the trust'.[23] Under trust law, the settlor would be E as the provider of the trust property.

Certainty of subject-matter

The approach taken by the OGC trust deed is not to attach the trust to the contractor's right to the certified sum[24] but to the benefit of a bank account set

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23 *Re Lehman Brothers International (Europe) (In Administration)* [2010] EWCA Civ 917, [2011] 2 BCLC 184, para [67]; affirmed by the Supreme Court [2012] UKSC 6.

24 In the Australian case of *Stork Electrical Pty Ltd v Leighton Contractors Pty Ltd* [2000] QCA 517 (Queensland CA), a managing contract provided for payment by the employer of sums due to subcontractors and consultants direct into a trust account set up by the contractor. The balance of the certified sum was payable to the contractor outside the trust in the ordinary way. At first instance it was held that the arrangement gave rise to a trust of the certified sum, and of the employer's promise to pay that sum into the trust

up at the inception of the project. Strictly speaking, the subject matter of the trust is the credit balance at the bank. The bank owns the money but owes an unsecured debt to the account holders in an equivalent amount.[25] There is no vault somewhere with coins and notes representing the amount 'paid in'.[26] In law therefore, a PBA takes effect as a trust over the chose in action owed by the bank to the account holders as legal owners in favour of the contractor and the named suppliers as beneficial owners listed in the monthly authorisation in the proportions which their individual debts bear to the whole fund as tenants in common in undivided shares.

It appears from the above that the account remains open even when there is a nil balance and that the intention is that 100% of the fund be paid out each month. Unless and until the account is in credit, is there only an intention to create a trust every month? This interpretation would be consistent with the express words of the deed which refer to a trust of the 'monies paid into the bank account' rather than 'monies to be paid in over the contract period'. Against this, it could be argued that it is theoretically possible to have a trust of future property, provided value is given, and that as the PBA could be in force for a number of years, the court might view it as one long trust arrangement rather than a series of alternating trusts and contracts to create trusts. In a recent case on the requirement for trust property, Briggs J stated: 'Subject matter certainty requires not only that the identity of the shared fund is certain, but also that the proportionate amount of each alleged beneficiary's share is also certain.'[27] This aspect is considered in the following section.

Certainty of objects

There are two aspects to consider: the identity of the beneficiaries, and the proportions in which they share the fund.

A PBA is intended to be a fixed trust in which every beneficiary is identifiable. An optional clause designed for use with an earlier edition of the

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account. On appeal, Thomas JA agreed with this analysis at para [69], but the majority disagreed. It does not follow from the fact that an account balance is the subject matter of a trust that the parties must have intended a trust of the antecedent debt. The situation is different from that in *Re Tout and Finch* [1954] 1 WLR 178 (Ch), in which unpaid subcontractors obtained a declaration that a contractor in liquidation held its right to payment of retention in trust for them and that the liquidator was bound to pay them an amount equivalent to their proportion on receipt of the retention from the employer. In that case the subcontract declared a trust over the employer's debt to the contractor. There could however be a trust of the employer's promise to the contractor to pay the 'certified sum' into the account under cl 2.2 of the trust deed (see above).

25 *R v Preddy* [1996] AC 815 (HL), page 841.

26 See also *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] QB 728, 748-751 (QBD Comm); and *Customs and Excise Commissioners v FDR Ltd* [2000] EWCA Civ 216, [2000] STC 672, in which Laws LJ stated at para [36]: 'It is, even nowadays, not difficult to be beguiled by the old model of a transfer *in specie*, when money in the shape of tangible coin was moved from one place, and one owner, to another place and another owner.'

27 *Re Lehman Brothers International (Europe)* [2010] EWHC 2914 (Ch, para [243], affirmed [2011] EWCA Civ 1544.

NEC form took the form of a discretionary trust for the whole supply chain.[28] A fixed trust in favour of the 'supply chain' may well be void for uncertainty because there is no end point. How far would it extend – to a manufacturer and its suppliers, to an equipment lessor etc? This problem is dealt with by the requirement that all named suppliers become parties to the trust deed.[29]

However, not every named supplier may be owed a debt every month. For example a groundworks subcontractor may remain a party to the trust deed long after its works have been completed in order to await the release of retention, whereas a fit-out subcontractor might be added as a named supplier before it commences work. Even so, the list of named suppliers intended to benefit from each certified sum will normally be complete and remain unchanged between certificate and payment. Thus, the third criterion is satisfied and a trust would be constituted, on the account being funded, for the benefit of named suppliers in proportions to be ascertained in accordance with the trust deed. In the *Lehman* case referred to above Briggs J observed:

> 'A trust does not fail for want of certainty merely because its subject matter is at present uncertain, if the terms of the trust are sufficient to identify its subject matter in the future.'[30]

Clause 2.3 of the trust deed says that the amounts owed to them are set out in 'the Account Holder's instructions to the Bank'. This expression is repeated throughout the deed, which also refers to payment being 'authorised' by the account holders. There is no requirement that the instructions take any particular form. Clause Z3.10 states that the contractor prepares a document called the 'authorisation', signs it and sends it to the project manager for signature by the employer and submission to the bank.[31] In practice, payment will be made through an electronic funds transfer system such as BACS, into which either the bank inputs the data contained in the authorisation or the bank sponsors the account holder(s) acting by their mandated representatives to do so.

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28 See the comparative table in Davis and Odams (editors) *Security for Payment* (Construction Law Press, King's College London, 1996), pages 27-47.

29 This was the problem in *OT Computers Ltd v First National Tricity Finance Ltd* [2003] EWHC 1010 (Ch). A retailer set up two trust accounts shortly before going into administration. One was in favour of customers and was valid as both the identity of and the debt owed to each customer could be ascertained; but the other, which was in favour of 'urgent suppliers', was imperfectly constituted as the court was not in a position to decide which supplier should be classed as 'urgent'.

30 *Re Lehman Brothers International (Europe)*, note 27, paras [225], [245]-[247], affirmed [2011] EWCA Civ 1544.

31 This fixes the suppliers' entitlement as trust beneficiaries, even if they believe that the figure inserted in the authorisation is incorrect. In *Re Sendo International Ltd* [2006] EWHC 2935 (Ch), [2007] BCC 491, two trust funds were set up for the benefit of creditors incurring trading debts to a company after a fixed date. The creditors were identified by name and amount in a schedule. After the company went into administration, two creditors claimed to be owed more than their scheduled debts and that it was incumbent on the trustees to ascertain in the case of every creditor exactly what debt the company incurred in the trading periods covered by the trust deeds. It was held by Blackburne J at para [32] that the schedule was the determining document governing distribution even if a creditor had been omitted or its actual debt was different.

There is no provision for a separate document in the JCT version of the PBA, which apparently relies on the contractor's application for payment to evidence the proportions in which the fund is to be held. The NEC approach seems preferable, under which the authorisation is a trust document showing the final net sums payable, whereas the contractor's application is a contractual document showing gross sums capable of reduction should the employer or the contractor serve withholding or 'pay less' notices. The JCT approach could render it impossible to make a set-off against a certified sum as there is no power in the trust deed to reduce a beneficiary's entitlement once it has vested. This is in contrast to the JCT retention trust, where the trust is integrated into the standard form and the employer is given an express right of recourse against the fund.[32] In case of conflict, the trust deed takes precedence over the contract (cl 3.1.2 of the OGC deed).

Dealing with set-off

I have mentioned a potential set-off problem with the JCT version. Clause 50.2 of NEC3 defines the amount due at the assessment date as 'the Price for Work Done to Date ... less amounts to be paid by or retained from the *Contractor*'. It is not clear whether this is intended to embrace set-off in general or be limited to the contractual set-off of liquidated damages and withholding of retention. If the former, it is a way of ensuring that the payer's cross-claims are taken in account in the formation or constitution of the receivable.

The clause is not clear enough to exclude the common law expressly or by implication. It will therefore apply to the contract. In practice, it seems that the project manager makes an assessment of the value of the employer's cross-claim and reduces the contractor's application accordingly, leaving it to the contractor to bring an adjudication to correct the certified amount if necessary. This approach is stepped down to subcontracts. The effect of the clause is to give the payer two opportunities to set off, before and after the certificate is issued. This expands on the payer's rights at common law since neither the existence nor the exercise of a right of equitable set-off has the effect of extinguishing or reducing the liability of either party to the other.[33] This may explain why cl Z3 does not refer to set-off either by employer or contractor. It is not clear how the time limits for giving notice to the relevant receiving parties under option Y relate to the order of events in Z3.7-Z3.12. Those clauses do not refer to the certificate.

Set-off could be relevant to a discussion on the PBA for various reasons. First, it could affect the amount the employer pays into the account and the extent to which it gets a good discharge. Second, it may result in a shortfall which the contractor may or may not be liable to make good before the final date for payment. If the contractor does not make good the entire shortfall, it

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32 See *Construction Insolvency*, note 20, chapter 10.
33 *Fearns v Anglo-Dutch Paint & Chemical Co Ltd* [2010] EWHC 2366 (Ch), para [25].

is suffered rateably by the contractor and the subcontractors.[34] Finally, where set-off is made by the contractor against a subcontractor, it imposes an additional burden on the contractor to notify the project manager of net sums due to the subcontractors in good time to ensure that only net figures are inserted into the authorisation.

Termination of the contract/trust

The other major area of principle covered by the OGC deed concerns the effect on a PBA of the termination of a main or subcontract. The definition given to the Term of the trust deed is:

> '... from the date of this Deed until such time as all monies due to the Contractor and the Sub-Contractors under the Contract and/or the Sub-Contracts have been paid in full.'

As well as interim payments, it appears that the account is to be used for any receivable which is capable of being certified for payment.

It is worth noting that the definition of 'Term' relates to the trust deed rather than the trust. A trust comes to an end when the trust property has been fully paid out. Clause 7.2.1 provides that the deed terminates automatically if 'the Contract terminates and all monies have [been] paid out from the Bank Account'. Although disbursement from the account is made a condition of the deed terminating, cl 7.3 then provides that on termination of the deed, all moneys held on trust are to be promptly paid out to the beneficiaries! It is possible to make sense of cl 7.3 by referring it back to cl 7.2.1 which provides for termination of the PBA by consent. At any rate, the intention is that on a termination of the contract, the trust should be operated in favour of the beneficiaries.

Clause Z3.15 provides that on the project manager issuing a termination certificate, no further payment is made into the PBA. The certificate is issued under cl 90.1 which provides for the termination of the contractor's 'obligation to provide the Works'. Clause 93 (Payment on termination) is silent on the effect of termination on the PBA. Construing cl Z3.15 of NEC3 and cl 7.2.2 of the trust deed together, after a termination certificate there will be no further payment in, and any balance there may be at that moment will be paid out in the normal way. Any other payment due under cl 93 could not be made through the PBA.

This approach seems to be in conflict with the suspension of payment which occurs after an insolvency termination under a JCT form. It is not clear why the employer should lose this valuable security for payment. As there is no suspension of payment on a termination under the NEC3 form, and the OGC deed is based on the NEC philosophy, the failure to preserve this security is understandable, but no attempt was made to reinstate it in the JCT documentation.

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34 This would probably be the case even without express provision: *Commerzbank Aktiengesellschaft v IMB Morgan Plc* [2004] EWHC 2771 (Ch), [2005] 1 Lloyd's Rep 298, paras [47]-[48].

3 Is a PBA valid on the contractor's insolvency?

Basic principles

Insolvency law is founded on the equitable maxim 'equality is equity', but the equality in question is not literal but proportionate.[35] It means that, where a company enters liquidation or administration, and the net proceeds of sale of its property are insufficient to pay unsecured non-preferential creditors in full, they must share rateably, each receiving the same proportion of his debt.[36] It is not possible to contract out of this principle. However, it is possible for the company before insolvency to grant an interest in its property by way of security which removes that property from the scope of the principle and enables the secured creditor to get paid ahead of others by selling that property and keeping the proceeds to the extent of his debt. Security is normally taken by way of charge, but a trust can also be used for this purpose. Whether a trust confers an absolute beneficial interest or an interest by way of charge is a question of construction in each case.

An insolvency practitioner appointed over the contractor will investigate whether the PBA could be challenged as an attempt to contract out of the equality rule or as an unregistered charge on the contractor's property. He will also consider the potential application of statutory remedies accorded to him, notably the power to apply to invalidate an action taken by the company in the run up to insolvency as a preference. I consider each in turn.

The equality rule: two sub-rules

In a recent case, the Supreme Court analysed the equality principle and found that it has two sub-rules.[37] The *pari passu* rule is that a creditor cannot contract with the company to receive more than its proportionate share. The anti-deprivation rule is that a creditor cannot by contract obtain the right to remove property from the company on its liquidation or administration, reducing the value of the insolvent estate. To use Professor Goode's analogy, the first prevents a creditor from taking more than its fair share of the pie; the second prevents it from reducing the size of the pie itself.[38] The distinction between the sub-rules is not clear cut;[39] but it is important to consider which aspect is dominant as they adopt different criteria. As the wider of the sub-rules, let us take *pari passu* first.

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35 *Re Golden Key Ltd (In receivership)* [2009] EWCA Civ 636, para [3].

36 This applies to voluntary liquidation (Insolvency Act 1986 s107), compulsory liquidation (Insolvency Rules 1986 r4.181) and administration where the administrator makes a distribution to unsecured creditors (1986 Rules, r2.69).

37 *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38, [2011] 3 WLR 521, para [1].

38 Roy Goode, '*Perpetual Trustee* and flip clauses in swap transactions' (2011) 127 LQR 1, page 4.

39 *Belmont Park*, note 37, paras [58], [123].

The *pari passu* rule

The leading case in this area is *British Eagle International Airlines v Compagnie Nationale Air France*.[40] Unfortunately, although it is a decision of the House of Lords and therefore of the highest authority, the general view is that it was wrongly decided.[41] It has, in Gerard McCormack's striking phrase, 'cast an invalidating spell' over *bona fide* commercial agreements and created an air of uncertainty about the scope of the *pari passu* rule.[42]

British Eagle concerned a clearing-house system operated by IATA, which netted off each month all sums arising out of trading between member airlines. The intention of the scheme was that a debt would arise between each member airline and IATA rather than between the airlines themselves. IATA would collect sums due from net debtors and pay sums due to net creditors. When British Eagle went into liquidation it was a net debtor to IATA in that the value of services received from other airlines in the preceding month was greater than the value provided to them by British Eagle. However, the liquidator found that as against one airline, Air France, the company was a net creditor. He argued that the clearing-house system was void and that he was entitled to recover the net debt direct from Air France. By a majority, the House of Lords held that the clearing-house infringed the *pari passu* rule. Any credit which British Eagle had against an individual airline such as Air France constituted its property – which had to be distributed among its creditors in accordance with the statutory scheme. Any debit would be treated as an unsecured claim in the liquidation.[43]

In *British Eagle*, the liquidator was prevented from collecting what he regarded as a debt due from an individual debtor because the communal clearing-house required it to be netted off. In the case of a PBA, the complaint would be that a debt which would ordinarily be the contractor's property available for distribution to its creditors in general is appropriated as the source of payment to creditors under one specific contract, distorting the principle of *pari passu* distribution, in that PBA creditors stand to receive a higher proportion of their debts than the others. This brings us back to the question posed earlier: what happens to the certified sum?

The clearing-house system in *British Eagle* dealt with ordinary unsecured debts. However, it is well established that property held in trust falls outside

40 *British Eagle International Airlines Ltd v Compagnie Nationale Air France* [1975] 1 WLR 758 (HL).

41 See Gabriel Moss QC 'Should *British Eagle* be extinct?' (2011) 24(4) Insolvency Intelligence, pages 49-54.

42 Gerard McCormack '*Pari Passu* distribution and construction contracts', in Davis and Odams, note 28, page 98.

43 One of the dissenting judges, Lord Morris, argued (page 768) that the company was not owed a debt by Air France. Its only property was the contractual right to have its debits and credits netted each month and to payment from IATA if it emerged as a net creditor. That right was not taken away on liquidation. On the contrary it was honoured when the company was found to be a net debtor of IATA.

an insolvent estate.[44] The difference between the two situations can be illustrated by *Carreras Rothmans v Freeman Mathews Treasure*.[45] In that case, a tobacco company placed funds in a special account to pay debts incurred by its advertiser to third parties. It was held that the money was paid for a specific purpose and that the balance of the account at the date of the advertiser's liquidation remained the property of the tobacco company. By analogy, if the PBA is in funds when the contractor enters administration or liquidation, payments out to the named suppliers would not be invalidated under the *pari passu* rule, as the account is clearly not the contractor's property.[46] However, the position is different where the account has not been funded.

In *Carreras Rothmans*, some of the debts owed by the tobacco company had not been paid into the account by the date of liquidation. In respect of these, Peter Gibson J stated:

> 'Mr Potts submitted that notwithstanding the July agreement [the trust arrangement] the debtor/creditor relationship subsisted between the plaintiff and the defendant; on its true construction it provided merely for the discharge of the debt owed to the defendant in a particular manner. In my judgment Mr Potts is correct in that submission. Immediately before the July agreement the defendant had a book debt owed to it by the plaintiff. Immediately after the July agreement the defendant, as Mr Higham accepted, *still had a valuable right against the plaintiff which it could enter in its books*. Mr Higham said that that right was not a debt but the contractual right to enforce the plaintiff's obligation to constitute the trust by paying the moneys owed into the special account. He accepted that if the July agreement had provided for payment to a trustee other than the defendant, the trustee would have had no right to enforce payment. Similarly only when the trust was constituted did the third parties acquire any rights. No debt in any sense of the term was owing to the defendant as trustee. *The position would of course be different if the defendant had constituted itself trustee of its book debt*, but the plaintiff does not contend for that result. In my judgment, on a proper analysis of the July agreement, *it did not discharge or replace the defendant's book debt which remained an asset of the defendant until that debt was discharged by payment by the plaintiff into the special account.* That did not occur in respect of the July debts and accordingly the July agreement is ineffective in purporting to appropriate to the third parties any moneys which the plaintiff might pay the defendant to discharge its debt. Therefore the whole of the sum of £780,000 is payable by the plaintiff to the defendant. [*emphasis added*]'[47]

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44 For a recent example of a commercial trust created as a protection against insolvency, see *Mills v Sportsdirect.com Retail Ltd* [2010] EWHC 1072 (Ch), [2010] 2 BCLC 143 (which concerned the intention to create a trust).

45 *Carreras Rothmans Ltd v Freeman Mathews Treasure Ltd* [1985] Ch 207 (Ch).

46 Compare *Re Lewis's of Leicester Ltd* [1995] BCC 514 (Ch), in which a challenge to a trust account based on the *pari passu* rule was rejected.

47 *Carreras Rothmans*, note 45, pages 228-229.

If the analysis suggested earlier in this paper is correct, there is no trust of the certified sum. The tobacco company argued that as a result of the trust arrangement (the July agreement), it ceased to owe debts to the advertiser, only a duty to pay equivalent amounts into the special account. This argument was rejected by the court. Similarly, it would not be open to the employer under a PBA to deny that before the account was funded, the certified sum was a debt enforceable at the instance of the contractor. It appears to follow that to apply the PBA to a certified sum owing at the date of liquidation or administration would be in breach of the *pari passu* rule. The sum would be payable to the contractor subject to the other terms of the contract.

The anti-deprivation rule

The anti-deprivation rule 'is a general principle of public policy which (in the traditional phrase) prevents a fraud on the insolvency statutes'.[48] The principle is directed at deliberate, intentional attempts to evade the equality rule that the debtor's property as it stands before liquidation should be made available for distribution as the insolvent estate.[49] A classic example is the building case of *Ex parte Jay, In re Harrison*,[50] in which a contract provided that on the builder's bankruptcy, the employer could forfeit the builder's plant and materials. This is different from the *pari passu* rule, which applies to a transaction whether or not it is intended to take effect on insolvency. In *Belmont Park*, Lord Collins emphasised that 'in borderline cases a commercially sensible transaction entered into in good faith should not be held to infringe the anti-deprivation rule.' In further contrast to the *pari passu* rule, the 'anti-deprivation rule has no application where an entity is deprived by a person of its property prior to bankruptcy and on grounds which do not depend upon bankruptcy'.[51]

Lord Collins stated that it is desirable so far as possible to give effect to contractual terms which parties have agreed, especially in the case of complex financial instruments. The modern tendency is to uphold commercially justifiable contractual provisions which have been said to offend the anti-deprivation rule. The court should give the policy behind the rule a common sense application such that it does not apply to '*bona fide* commercial transactions which do not have as their predominant purpose, or one of their main purposes, the deprivation of the property of one of the parties on bankruptcy'. It should look to substance rather than form. On the facts in *Belmont Park* the rule was held not to apply, as the arrangement in question was 'a complex commercial transaction entered into in good faith'.[52]

When considering the PBA in the context of anti-deprivation, it is necessary to step back from the detail and recall its nature and purpose. According to the JCT version, a debt arises in favour of the contractor which is discharged by payment into the account. Once the trust takes effect, the debt becomes a fund

48 *Belmont Park*, note 37, para [121] (Lord Walker).
49 *Belmont Park*, note 37, paras [78] and [106] (Lord Collins).
50 *Ex parte Jay, In re Harrison* (1880) 14 Ch D 19 (Ch).
51 *Belmont Park*, note 37, paras [79] and [115].
52 *Belmont Park*, note 37, paras [103]-[108] (Lord Collins).

which is owned in equity by the contractor and the subcontractors in their respective proportions. The trustees assume the contractor's role as paymaster by distributing the fund, a small portion of which goes to the contractor. Any legal challenge would have to attack the validity of this form of discharge of a debt in the event of the contractor's administration or liquidation.

It is striking that there is no deprivation in the event of an insolvency termination: any balance in the project bank account held on trust is paid out to the beneficiary, even if the termination is triggered by the beneficiary's insolvency. Moreover, the PBA has been imposed by Government to facilitate a reduction in the cost of construction, to promote fairness and for other policy reasons, and is not intended to deprive the contractor's estate of its property. It seems to be an example of 'a complex commercial transaction entered into in good faith'. Reading the judgments in *Belmont Park* with a PBA in mind, it seems unlikely that the rule would be engaged.

In summary, the position appears to be as follows:

1. If the account has not been funded at the date of the contractor's administration or liquidation, then the certified sum will remain due to the contractor under both the NEC and the JCT versions of the PBA. It would be payable in full to the relevant insolvency practitioner for distribution to creditors subject to the employer's contractual set-off rights on termination and any conditions imposed by the court.[53]

2. If the account has been funded at that time and proportions in the fund have been identified by the authorisation but the process of paying out has not started or not been completed, then the amount standing to the credit of the account is held in trust and is not included in contractor's property. The trustees can administer the trust without reference to the insolvency practitioner: *Carreras Rothmans*.[54]

3. In this situation, under the JCT version, the certified sum has been discharged and the employer cannot be liable to the administrator for it.[55] A possible construction of cl Z3 of NEC3 taken as a whole is that the sum remains due until 'treated as' paid under cl Z3.13. If correct, there is an argument that payment out by the trustees after the contractor's formal insolvency will not discharge the employer's liability to the contractor for the certified sum, on the ground that the deeming provision infringes the *pari passu* rule.

4. The basis of the challenge would be that to 'treat' payments from the account as payment of the certified sum is equivalent to making a direct payment out of a sum owing to the contractor,

53 *Carreras Rothmans*, note 45, pages 228-229.
54 *Carreras Rothmans*: note 45.
55 A provision for discharge is a key term in a direct payment agreement or a payment trust: *PC Partitions v Canary Wharf Contractors* [2004] EWHC 1766 (TCC), paras [10] and [60]. See also *Rafidain Bank v Saipem* [1994] CLC 252 (CA).

something which has been invalidated as a breach of the *pari passu* rule in a number of cases.[56] On this view, the *pari passu* rule is infringed as the certified sum is deemed to be paid by satisfying one group of creditors in full, at the expense of the others. This could be important as the exegesis of anti-deprivation in *Belmont Park* suggests that a PBA would not infringe that rule, for reasons given above.

5. If the contractor's insolvency intervenes after the payment in but before the authorisation has finally identified the proportions owned by the beneficiaries, there are various possibilities. The first is that the trust fails and the money standing to the credit of the account is returnable to the employer (or possibly to the contractor under the JCT version) by resulting trust.[57] Second, the fund could be distributed equally, but this seems inequitable as the trust was intended as the means of payment for work done, and equality would give some beneficiaries a windfall at the expense of others. Third, the court could order a distribution on the basis of the breakdown attached to the certificate or an authorisation prepared in draft (if such exists, or perhaps on the evidence of the project manager of his assessment of the sums due at the final date for payment). Of these options, the third is the most likely. The trustees would be under a duty to do the best they can to identify the beneficiaries' respective interests. This would also apply to the contractor in administration.

6. Should the trust fail, the named suppliers might argue that the PBA ought to continue as an escrow agreement on the same terms.[58] In this particular case, it seems that the event which releases the fund from escrow is the same as the event executing the trust, namely the agreement of the payment authorisation. Unless the administrator is prepared to sign it for commercial reasons, or could be ordered to do so by the court, the escrow event would never happen.

56 In *HM Attorney General v McMillan & Lockwood* [1991] 1 NZLR 53 (New Zealand CA), the contract allowed direct payment at the employer's discretion 'as if the [subcontractor] were a lawful assignee of the Contractor'. In other words it treated the subcontractor 'as if' it had a proprietary interest in the certified sum. See also *Joo Yee Construction v Diethelm* [1990] MLJ 66 (High Court of Singapore) and *B Mullan & Sons (Contractors) Ltd v Ross* (1995) 54 Con LR 163, 86 BLR 1 (Northern Ireland CA).

57 A resulting trust arose on the failure of the express trust in *OT Computers*, note 29, para [27], although that was because no supplier schedule was prepared at all. Oddly, in view of the drafting of cl 2.5 of the OGC deed, the credit balance may even revert to the Crown as *bona vacantia*: *Westdeutsche Landesbank v Islington London Borough Council* [1996] AC 669 (HL), page 708. See generally Underhill and Hayton, *Law of Trusts and Trustees* (London, Lexis-Nexis, 18th edition 2010), Article 23.

58 In *Challinor v Juliet Bellis & Co* [2011] EWHC 3249 (Ch) Hildyard J stated '... escrow accounts and escrow arrangements are commonplace and accepted in commercial transactions, denoting that notwithstanding transfer of a fund by X to Y property in the fund does not pass from X to Y until satisfaction of the agreed escrow event or condition. ... The essence of such an escrow is an undertaking not to treat the funds transferred by X as the property of Y unless and until the escrow event or condition is satisfied. The effect is that X cannot undo or recall the transfer pending fulfilment of the escrow event; but Y cannot use the funds as his own until such fulfilment' (paras [35]-[36]).

PBA as preference?

A preference claim is a statutory remedy afforded to administrators and liquidators by section 239 of the Insolvency Act 1986, which provides:

> '(2) Where the company has at a relevant time (defined in the next section) given a preference to any person, the office-holder may apply to the court for an order under this section.
>
> (3) Subject as follows, the court shall, on such an application, make such order as it thinks fit for restoring the position to what it would have been if the company had not given that preference.
>
> (4) For the purposes of this section and section 241, a company gives a preference to a person if—
>
> (a) that person is one of the company's creditors or a surety or guarantor for any of the company's debts or other liabilities, and
>
> (b) the company does anything or suffers anything to be done which (in either case) has the effect of putting that person into a position which, in the event of the company going into insolvent liquidation, will be better than the position he would have been in if that thing had not been done.
>
> (5) The court shall not make an order under this section in respect of a preference given to any person unless the company which gave the preference was influenced in deciding to give it by a desire to produce in relation to that person the effect mentioned in subsection (4)(b).'

The 'relevant time' referred to in section 239(2) is six months before the onset of insolvency, for example the commencement of an administration, or two years where the creditor is a connected person. The company must have been insolvent at the time of the preference or become so as a result.

In practice, most successful preference claims concern a change of position by the debtor in response to its impending administration or liquidation. Most commonly, the debtor singles out one creditor above others, and the preference consists in a payment for services, such as the £400,000 paid to the director in the construction case *Re DKG Contractors*;[59] or the repayment of the directors' loan accounts in *Wills v Corfe Joinery*.[60] There are several reported cases of preference in connection with direct payment under a building contract in Australian law.[61] As far as I am aware, there are no equivalent cases under English law. In the UK and other common law jurisdictions, an insolvency-based challenge to a direct payment is usually made by invoking the *pari passu* rule.[62]

59 *Re DKG Contractors* [1990] BCC 903 (Ch).
60 *Wills v Corfe Joinery* [1997] BCC 511 (Ch).
61 *Construction Insolvency*, note 20, page 655. The Australian law on preference is however completely different from English law.
62 *Construction Insolvency*, note 20, chapter 17.

A declaration of trust creates a beneficial interest in the trust property in favour of a third party. A trust can in theory amount to a preference where the interest is created in favour of an existing creditor.[63] If we turn to the OGC precedent, however, there is no declaration of trust by the contractor. The trust is constituted by the employer as settlor funding the account on the terms of the PBA. The account is new property in the form of a debt owed to the account holders by the bank. Under JCT cl X.3, on a payment in by the employer, the contractor ceases to be a creditor of the employer and becomes a beneficiary under the trust in respect of its fee. It appears to follow that in this case the trust itself cannot be a preference as the disposition in favour of creditors is not made from the debtor's property. If this is correct there would be no material from which a preference claim could be constructed.[64]

Absent unusual circumstances, the contractor will have entered into the contract in the ordinary course of trading, for 'proper commercial considerations' as Millett J stated in *Re MC Bacon*.[65] The only 'desire' present is to make a profit or at least to gain turnover. It did not 'suffer anything to be done', as the inclusion of the trust was a requirement of the employer; it was not a factor within its control.[66] If the contractor were to object to the inclusion of the PBA, its tender would be rejected. It has no choice but to enter into the PBA if it wishes to undertake the work.[67] On public sector contracts, the PBA is an instrument of government policy. It is the Cabinet Office, not the contractor, which desires to prefer the project subcontractors on the contractor's liquidation, and there is nothing objectionable under insolvency law in using a trust to protect payments. Subjectively the contractor is more likely to resent the PBA because of the loss of cash flow it suffers as a result.

The focus then shifts to the effect of cl 2.2 of the OGC precedent combined with JCT cl X.3. Could the contractor's agreement to be discharged by the employer's payment into the bank account be a preference? It is hard to see how discharge of payment under a main contract could prefer a subcontractor, and in this situation the employer is a debtor not a creditor; the discharge is part of the contractual machinery needed to constitute the trust. Although when compared with the traditional system of payment the discharge smacks of an undervalue or the divestment of property, when construed as part of the PBA it is simply a piece of the contractual jigsaw. The logic of a PBA is that where most of the construction work is carried out by subcontractors there is no necessary reason why payment for their work should in the first place be made to the contractor. To the extent that the discharge could satisfy the

63 *Re Farepak Food and Gifts* [2006] EWHC 3272 (Ch), [2008] BCC 22, para [52]; compare *Thirty-Eight Building Ltd (No 2)* [2000] BCC 422 (Ch). See also *MacJordan v Brookmount Erostin*, note 22, page 589; also *Re Global Trader Europe Ltd* [2009] EWHC 602 (Ch), [2009] 2 BCLC 18, para [110].

64 *Mundy v Brown* [2011] EWHC 377 (Ch), [2011] BPIR 1056, paras [28]-[29].

65 *Re MC Bacon* [1990] BCC 78 (Ch), page 87. See also *Re Lewis's of Leicester Ltd* [1995] BCC 514 (Ch).

66 See *Re Parkside International* [2008] EWHC 3554 (Ch), [2010] BCC 309.

67 Compare *Re Hawkes Hill Publishing Co Ltd* [2007] BCC 937, [2007] BPIR 1305 (Ch), para [33].

requirement of something done or suffered to be done, it would fail the requirement for desire for the reasons given above.

Transactions at an undervalue

It is also worth mentioning section 238 of the Insolvency Act 1986, which concerns transactions at an undervalue. The section concerns any transaction under which the money received by the contractor is significantly less than the value given by it. The question of value can give rise to difficulties in practice. In *Buildspeed Construction v Theme* it was held that the consideration paid by the purchaser under a novation was significantly less than the value remaining in the contract.[68]

With a PBA, the discharge of the certified sum is part of a payment scheme whereby the contractor only receives payment for the work it actually does, even though technically a debt for the value of everyone's work is created in its favour. When viewed in this context, the effect of the discharge is neutral. The discharge only takes effect if the employer makes the payment in, and the fund then stands as an informal security for the contractor against the employer's insolvency. To the extent that the contractor provides additional value by incurring liability to subcontractors and protecting the employer against claims by them through privity of contract, that value is balanced by the security constituted by the account. Even if the employer provides insufficient value for the discharge, there is a statutory defence that the transaction was entered into by the contractor in good faith to carry on its business, and that there were reasonable grounds for believing that the transaction would benefit it. This would appear to apply here.

PBA as unregistered charge?

A charge granted by a limited company falling within the categories listed in section 860 of the Companies Act 2006 must be registered with the registrar of companies within 21 days of its creation otherwise it will be void against a liquidator, administrator or creditor of the company under section 874 of the 2006 Act. The category relevant here is a charge on book debts. Case law in this area is extensive,[69] but there is only one authority which has considered the issue in connection with a trust account grafted on to a building contract: *Lovell Construction v Independent Estates*.[70] In that case, Judge James Fox-Andrews QC held:

> 'It was the intention of the parties that the joint account should be a conduit by which moneys due from Independent to Lovell pursuant to certificates issued by [the architect] should be channelled to Lovell. *This was not in substitution of any rights Lovell had under the JCT contract.* These were additional rights and in one sense can be described as a form of security, but it appears reasonable to infer that it was the

68 *Buildspeed Construction v Theme* [2000] SLR 776 (High Court of Singapore).

69 See Lightman and Moss, *The Law of Administrators and Receivers of Companies*, (London, Sweet & Maxwell, 5th edition 2011), chapter 3.

70 *Lovell Construction v Independent Estates* [1994] 1 BCLC 31 (TCC). For a detailed analysis of this case, see *Construction Insolvency*, note 20, pages 272-276.

> intention of the parties that Lovell would look to the joint account rather than to their rights under [the building contract] for the honouring of certificates. I have reached the conclusion that the machinery established by the escrow agreement was for effecting payment and was not for establishing security. Since on the happening of certain events moneys in the account might be paid out either to Lovell or Independent, both had a beneficial interest in the moneys. I find that the escrow agreement established a trust and not by way of charge under which the legal interest was in the trustees and the beneficial interests were in Lovell and Independent.' [*emphasis added*][71]

The arrangement in that case has been called a 'whole contract sum PBA',[72] in that the employer paid into the account monthly in advance an amount representing the estimated value of the work to be done during the following month in accordance with a schedule drawn up at the inception of the contract. There was a separate trust deed and a letter to the parties' solicitors appointing them as trustees of the account. The JCT contract was amended.

To fall within section 860 of the Companies Act 2006, there would have to be an arrangement which could properly be described as a charge granted by the contractor. There is a clear point of distinction between the OGC precedent and *Lovell v Independent*. In the latter case, it was the liquidator of the employer who was arguing for a charge over a book debt, ie the benefit of the account. In the PBA situation, it would be the administrator or liquidator of the contractor, and in that case there would be a book debt to consider, namely the unpaid certified sum.

The argument would be that by entering into the PBA the contractor charged sums due or to become due from the employer as security for its liability for payment under the subcontracts. The chargees would be the subcontractors who became parties to the trust deed. Presumably it would be a fixed charge, on the basis that payment can only be made into the trust account and dealt with in accordance with the trust.[73]

According to the JCT documentation, payment into the account discharges the debt owed by the employer. The balance of the account formerly represented by the debt is disbursed in satisfaction of the 'secured' obligation. In effect, the obligation to the subcontractors is discharged by appropriating a surrogate of the 'charged' property which ceases to exist. A similar situation arose in *Carreras Rothmans*[74] in which Peter Gibson J rejected an argument that a special account to pay third party creditors amounted to a charge:

> 'I do not see how the rights of the third party creditors to enforce the primary trust relating as it does to the moneys in the special account can be said to amount to a charge on any book debt of the defendant. The

71 *Lovell Construction*, note 70, paras [36]-[37].

72 Chris Snodin, 'Does use of a project bank account ensure that subcontractors are paid and are paid on time?' MSc dissertation, Centre of Construction Law and Dispute Resolution, King's College London (2010), page 29.

73 See *Re Harmony Care Homes Ltd* [2009] EWHC 1961 (Ch), [2010] BCC 358.

74 *Carreras Rothmans*: note 45.

book debt of the defendant owed to it by the plaintiff is discharged no later than on payment of the moneys into the account and only on such payment do the rights of the third parties arise. Their rights to enforce against the defendant as trustee the carrying out of the primary trust seem to me to be wholly different from the rights of a chargee. There is no equity of redemption in the defendant. In reality what was created by the July agreement was a method of settling the plaintiff's debt to the defendant and the defendant's corresponding debts to the third party creditors without any intention to create a charge in favour of the third party creditors who knew nothing of the July agreement until the third party creditors' representatives were told of it after the commencement of the liquidation. Further, even if the rights of the third parties were charges, and the security were avoided, that would not in my judgment prevent the plaintiff from exercising its equitable right to enforce the primary trust.'[75]

In reality, a PBA facilitates an out-and-out transfer under the protection of a trust, rather than creating a security.[76] It would therefore appear that the PBA is not a charge within the meaning of section 860.[77] Even if it were, a charge over an account is not thought to amount to a charge over a book debt.

Conclusions

The aim of this paper has been to try and understand the legal basis of the project bank account. It is challenging to fit the concept into established legal categories. A PBA cuts across the contract chain. By using a trust deed, it imports equitable principles. Mixing contractual and equitable obligations creates complexity.[78] There is as yet no case law on the PBA, and minimal authority on the NEC form. It is therefore necessary to refer back to basic principles.

We have tested the concept by speculating on the effects of default or insolvency of each of the parties to the PBA. This is an area where an emphasis on practicality can stifle thinking. I am unsure about some of the conclusions, but I hope in the process to have identified the areas of law engaged by a PBA and to have found some pertinent questions, such as:

- Under the NEC version, is the certified sum discharged on payment into the account, or only on payment out of it?

75 *Carreras Rothmans*, note 45, page 227.

76 See Louise Gullifer (editor), *Goode on Legal Problems of Credit and Security*, 4th rev edition, 2008, para.1-16. Compare also *Gray v G-T-P Group* [2010] EWHC 1772 (Ch), [2011] BCC 869*; Obaray v Gateway (London) Ltd* [2004] 1 BCLC 555 (Ch); and *Re ILG Travel Ltd* [1996] BCC 21 (Ch), in which a commercial trust was construed as an equitable charge.

77 It is worth noting the observation by Lord Cross in *British Eagle v Air France*, note 40, page 780: 'But the parties to the "clearing-house" arrangements did not intend to give one another charges on some of each other's future book debts. The documents were not drawn so as to create charges but simply so as to set up by simple contract a method of settling each other's mutual indebtedness at monthly intervals'.

78 Contract and trust have been described as 'mutually exclusive concepts': Underhill and Hayton, note 57, Article 1.23.

- Is the account funded with money belonging to the employer or the contractor?
- In the event of non-payment into the account, are the parties' contractual remedies immediately available, or must they first act collectively, eg by seeking a mandatory injunction against the employer?

Conceptually a PBA can be seen as a legal structure which recognises the commercial reality of a project. By converting a certified sum from a debt into a fund, a PBA makes concrete the image which the industry has always had of a certified sum being 'passed on' down the chain.

In summary, a PBA is not so much a bank account as a direct payment trust. As such, it is the most significant development in the field of payment for construction services since Part II of the Housing Grants, Construction and Regeneration Act 1996. In some ways, it is even more far-reaching than the Act. This is recognised by the Cabinet Office briefing, which claims that the PBA will 'revolutionise the way the construction supply chain gets paid'.[79] In contrast to the long and convoluted process of industry-wide consultation which led to the 1996 Act, however, this is a very quiet revolution.

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79 Cabinet Office, Project Bank Accounts briefing document: note 3.
80 Richard Davis, *Construction Insolvency* (Sweet & Maxwell, April 2011).

‘The object of the Society
is to promote the study and understanding of
construction law amongst all those involved
in the construction industry’

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