The problem of late payment in the construction industry

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Construction analysis: Following recent suspensions from the Prompt Payment Code for a number of construction companies, Rupa Lakha, partner at Charles Russell Speechlys LLP, looks into the problem of late payment in the construction industry and provides insight into potential solutions.

Original news

Seventeen companies suspended from Prompt Payment Code for late payments: LNB News 30/04/2019 44

The Chartered Institute of Credit Management (CICM) has announced that 17 businesses have been removed or suspended from the Prompt Payment Code (PPC) for failing to pay their suppliers within the specified time limit. The majority of the suspended businesses are construction companies, including Balfour Beatty Plc, Costain Limited, Interserve Construction and Laing O'Rourke. John Sisk & Son has been removed completely. Signatories to the PPC undertake to pay suppliers within 60 days (this is met by paying 95% of invoices within this period) unless there are exceptional circumstances.

What is the context to the problems surrounding late payment in the construction industry? Why have several construction businesses been removed or suspended from the PPC?

Late payment has long been an issue in the construction industry, with smaller businesses and those lower down the supply chain often most severely affected.

The introduction of the contractual payment provisions in the Housing Grants, Construction and Regeneration Act 1996 (HGCRA 1996) almost 25 years ago demonstrates this to be a long-standing problem.

To that end, statute has attempted to improve cash flow within the industry. For instance, the HGCRA 1996 bans 'pay when paid' clauses and makes it compulsory for construction contracts to contain an adequate mechanism for parties to be paid in instalments. Equally, the ethos of the PPC is to drive businesses ultimately to pay invoices within 30 days as normal practice, as well as adhering to other standards of good practice, such as not retrospectively changing payment terms.

However, the data that has been disclosed following the recent collapse of Carillion shows that the industry has a long way to go, and there is now a renewed focus to improve late payments within industry more generally. The government has, for instance, recently completed the consultation period on 'Creating a responsible payment culture: a call for evidence on tackling late payment' and is currently reviewing the feedback. The government consultation description acknowledged that, while the amount owed to smaller businesses in late payments had halved between 2012 and 2017, unfair payment practices still needed to be addressed.

The ambition of the PPC is well-intentioned—it sets out key targets in terms of prompt payment and good practice. The PPC also gives clear guidance about lead suppliers setting a precedent and encouraging other participants in the supply chain to follow suit. However, the PPC's operation in practice to date has been found lacking.

Set up in 2008 by the CICM on behalf of the government, the PPC is a voluntary code. As of September 2018, it had over 2000 signatories and many of these included well-known household names within the construction industry and beyond. Being a signatory of the PPC was intended to represent a public commitment to quality payment practices.

Carillion's demise has however demonstrated the failure of the PPC. Despite being a signatory of the PPC, it has become apparent that Carillion owed around £2bn to 30,000 suppliers, sub-contractors and other short-term creditors when it failed. Carillion is now known to have been a late payer forcing its supply chain to accept payment terms of 120 days as standard.

There is now a shake-up of the PPC and its implementation which is promised to create a more robust and transparent regime. Closer attention is now being paid to the practices of other signatories to the PPC that may be seen as failing to adhere to the PPC and the message appears to be clear—it is time to shape up or move out.

On 28 April 2019, CICM reported on the action of 17 companies who failed to meet the standard of the PPC. The second phase of its review is underway and there may be more names to follow. Those who have not been paying suppliers in compliance with the PPC are suspended but invited to make changes to their practices to pay suppliers promptly. For those who have failed to provide a plan for compliance going forward, they have been removed. Conversely, one company has been re-instated after filing data to show that it has been paying 95% of all invoices within 60 days for the last reported period.

Why is late payment such a problem in the construction industry?

Part of the culture within the construction industry operates on a system of 'trade credit' whereby businesses supply goods and services on credit, agreeing to defer payment for a period after delivery rather than requiring immediate payment. According to the Department for Business, Energy and Industrial Strategy's (BEIS) Longitudinal Small Business Survey 2017: SME employers, dated 24 May 2018, 50% of small and medium enterprises in the UK give their customers trade credit, rising to 84% in the manufacturing sector, 61% in the information and communication sectors and 56% in construction. The BEIS survey also identifies the construction sector as the industry in which late payment is most frequently reported as a problem and a major obstacle to business success.

Perhaps more fundamentally, the tough payment regime is driven by the power imbalance and the risk allocation through the supply chain. Risk tends to be passed down or along the contracting chain, with potential accumulation of delays at each point, administrative inefficiencies and the intentional use of late payments as a form of financing. With main contractors the initial point of call for employers, late payment has become a method of spreading or deferring payment risk and insufficient cash flow.

The nature and structure of the supply chain in construction sees suppliers reliant on each other, yet reluctant to challenge unfair practices for fear of losing business or gaining a reputation as being difficult. There is also a knock-on effect as cash flow becomes constrained.

Is the PPC effective in holding businesses to account?

The shortcomings of the PPC have been touched on above. The fact that it is a voluntary code and one that has historically lacked a formal and public reporting process has meant that it has not been as effective as intended.

Other than through media coverage of signatories who breach the PPC, there has been little to act as a deterrent to signatories for non-compliance as there has been no way to hold those in breach to account. Payment records are not reported and there has been little regulation of the PPC and its signatories.

Many businesses are not aware of the PPC or are unaware of or fearful to challenge a signatory's status. To that end, suppliers have had limited redress under the PPC if a signatory breaches its undertakings. If this occurs, suppliers can challenge the signatory's status, ultimately resulting in suspension or expulsion of the signatory from the PPC. However, by this time the damage may be done and, so far, informal media naming and shaming has not resulted in a sea change in terms of construction industry payment practices.

However, the recent review shows that the intention is there to raise more awareness about the PPC, encouraging suppliers to identify and raise breaches so that signatories can be held to account.

The fact that the first formal round of naming and shaming of PPC signatories has identified some familiar names with the promise of more to follow as well as the promise of more public reporting and regulation may now start to force businesses to actively address their shortcomings.

How are late payments in the construction industry governed by law? Have any changes been proposed?

In addition to the PPC, there have been a number of measures introduced by UK governments and the European Union to address the problem of late payment more generally, including:

- the Late Payment of Commercial Debts (Interest) Act 1998 (LPCD(I)A 1998), which created a statutory framework in the UK for tackling late payment. Pursuant to LPCD(I)A 1998, s 4(2A), if no explicit payment terms have been agreed, payment is assumed to be due after 30 days for the purposes of charging statutory interest. It also establishes maximum 30-day payment terms for transactions with public authorities and 60-day payment terms between businesses, unless they agree longer terms and this is not grossly unfair to the supplier
- in February 2018, the government amended the Late Payment of Commercial Debts Regulations 2002, SI 2002/1674 to expand the powers of trade bodies to challenge grossly unfair payment terms and practices on behalf of suppliers, in the hope that this would encourage more challenges to be brought
- the Public Contract Regulations 2015, SI 2015/102 require many public sector bodies to pay their suppliers within 30 days and to pass this payment term down the supply chain in new public sector contracts. Sub-contractors have also been encouraged to report cases of late payment in public sector supply chains to the Public Procurement Review Service
- the Reporting on Payment Practices and Performance Regulations 2017, SI 2017/395—the PPC Compliance Board, chaired by CICM's chief executive Philip King and including the small business commissioner Paul Uppal, regularly review the data reported by large companies under SI 2017/395 to ensure they are upholding their commitments
- the Business Contract Terms (Assignment of Receivables) Regulations 2018, SI 2018/1254 nullify contract provisions which restrict invoice assignment. SI 2018/1254 took effect on 24 November 2018 and applies to contracts entered into on or after 31 December 2018. Unlike in the past, this can enable suppliers to use invoices that they have issued to customers as security for finance in order to improve cashflow

Also, the government has recently indicated its intention to bar late payers from government bids. From 1 September 2019, any supplier who bids for a government contract above £5m per annum will be required to answer questions about their payment practices and performance with the expectation that they pay 95% of invoices in 60 days across all their business. Any supplier who is unable to demonstrate that they have systems in place that are effective and ensure a fair and responsible approach to payment of their supply chain may be excluded from bidding.

Is there another solution to combat late payment in the construction industry?

The government consultation indicates the government's focus on increasing transparency (reporting and exposing late payment) and board room accountability.

The government consultation also suggests other options which the UK government is considering to address late payment. Including:

- legislating for all company boards to give one of their non-executive directors specific responsibilities for the company's prompt payment performance
- creating a responsible payment culture in public sector contracts
- strengthening the government's own commitment to prompt payment with an ambition that it will pay 90% of its undisputed invoices from SMEs within five days and ensuring government departments have a dedicated non-executive director responsible for prompt payment
- using technology to improve payment practices and business productivity, including accounting software to help small businesses track their finances
- legislating for a definitive maximum payment term—although this has received mixed responses and not proved to be that effective in certain other jurisdictions

It will be interesting to see responses to the government consultation, including views on reforms to improve the PPC. It will be even more interesting to see government action in response to the feedback.

Another option that can be used to avoid late payment is a Project Bank Account (PBA). PBAs can be used to speed up the flow of project money through the supply chain, as well as protecting against upstream insolvency risks. PBAs are desirable in contracts because the emphasis is on prompt, transparent payments through promoting compliance with the PPC and Construction Supply Chain Payment Charter.

In a post Carillion world, PBAs are an increasingly attractive option for monitoring and ensuring fair payment processes. However, they can be relatively expensive to establish and maintain, and set-up and administration costs can be prohibitive on smaller projects.

While the UK government promotes the use of PBAs on public projects, there is no current or planned requirement for PBAs to be used in the private sector.

Interviewed by Thomas Jeffery.

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