

# Assign of the times or just assign of things to come

You may not have yet come across *The Business Contract Terms (Restrictions on Assignment of Receivables) Regulations* but you are likely to hear a lot more about them in coming months (in this briefing, we will call them the *Regulations*).

Beneath this rather mundane title lies well-intended legislation which has adopted an over-simplistic approach to the spectrum of payment arrangements in various industries, applying itself in circumstances well beyond its stated intention and leaving businesses and lawyers alike with a number of unanswered questions.

## The Regulations

**The proposed Regulations are made under the Small Business, Enterprise and Employment Act 2015 and are expected to be implemented in Autumn 2016. They have been developed with the commendable intent of supporting small businesses by removing barriers to factoring and other forms of invoice or receivables finance. That said, they have not been limited in application to small businesses, and larger businesses will also be affected.**

The Regulations are simple enough to summarise. They are to apply to any contract for the supply of goods, services or intangible assets other than contracts (i) for certain financial services, (ii) which create an interest in land or are an agreement for a tenancy; or (iii) are entered into by one or more parties acting for purposes which are outside their trade, business or profession. In contracts to which the Regulations apply, a term has "*no effect to the extent that it prohibits or imposes a condition or other restriction on the assignment of a receivable by a party to the contract*". In other words, any prohibitions or restrictions on the assignment of receivables will be legally ineffective. The only exceptions are where the term (i) provides that a receivable may only be assigned to a supply chain finance provider, or (ii) gives rise to a duty of confidence.

Construction contracts, subcontracts, purchase orders and professional appointments all seem to fall within the ambit of the Regulations. And of course, restrictions on assignment are commonplace in the construction industry. This briefing looks at issues that may arise.

### Key issues

- New legislation to enable access to receivables finance
- Not restricted to SMEs and can affect English law contracts outside the UK
- Not synchronised with UK construction legislation
- Uncertainty over set-off rights and possible conflict with some funding obligations
- May lead to changes to contract assignment clauses and deterrence

### **Who is affected?**

As indicated above, the prohibition applies to all business to business contracts and is not restricted to SMEs. The Government has confirmed this is its intention in its response to the consultation on the Regulations.

### **What type of assignment?**

The draft Regulations are intended only to apply to the assignment of "receivables" - defined as the right to be paid under a contract. Although the pre-legislative consultation focus was on the factoring of invoices, this evidently catches a situation where a contractor assigns in advance all of its rights to receive payments in respect of a contract.

What if a clause prohibits the assignment of the whole of the benefit of the contract? The wording of the Regulations suggests that such a prohibition will be ineffective only to the extent it affects the assignment of receivables – but it could have been made clearer that where a clause has a wider ambit it will still be left intact and will remain effective to prohibit other assignments. This has led some commentators to wonder if it would be safer to carve assignments of invoices or receivables out of wider assignment prohibitions in future, so as to ensure that the latter are enforceable as intended.<sup>1</sup>

### **Territorial scope**

The Government has suggested in its response to the consultation that the Regulations will only apply to business to business contracts which (i) are put in place after the commencement of the Regulations, (ii) are governed by English law, and (iii) include one party which carries on business within the UK. However, none of this is dealt with in the current draft Regulations.

It is unclear why the Regulations should apply outside the UK simply because a party carries on business in the UK. Many projects that currently adopt English law for their international construction and supply contracts and which are not otherwise connected with the UK are likely to be caught. By way of contrast, "fair payment" legislation in the construction industry has focussed on projects in the UK alone.

### **How does this fit with Construction Industry fair payment policy?**

One of the reasons employers and their lenders have traditionally sought to prohibit assignment of contracts by main contractors is that they want to ensure that the money they are spending/lending goes to the subcontractors and suppliers and people actually doing the work on the project – not to another financing organisation. Indeed for certain institutions such as Export Credit Agencies, their funding guarantees may be strictly dependent on compliance with utilisation/sourcing requirements (so where eligible export content is at subcontract level, the Regulations potentially create a direct challenge for additional main contract controls).

Additionally, the focus of Construction Industry payment legislation<sup>2</sup> has been to ensure prompt payment to contractors and subcontractors for the benefit of the whole contracting chain.

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<sup>1</sup> There is little data available as to how successful current prohibitions on assignment are. For example, many smaller businesses are known to utilise undisclosed/'phantom' assignments where invoices direct payment to an account with the name of the relevant corporate but which is in fact owned by a finance company.

<sup>2</sup> Most notably, the Housing Grants, Construction and Regeneration Act 1996, as amended by the Local Democracy, Economic Development and Construction Act 2009. The Regulations will apply to a number of contracts which do not fall under the scope of these Acts (including overseas contracts as mentioned above) although certain exclusions are very similar (e.g. finance agreements and agreements for transfers of interests in real estate).

At first glance, the Regulations seem to run counter to both of these imperatives. However, there is still a good empirical argument to be made that payment by employers to assignment-prohibited contractors does not always run through contracting tiers as it should do. And, of course, allowing factoring of receivables could, in principle, give contractors more flexibility to manage payments to their supply chain on time even where there are delays 'upstream'.

To this extent the Regulations can be seen as helping to facilitate objectives in the Construction Supply Chain Payment Charter (see box opposite), even if it was not previously countenanced that the Charter would be a legislative initiative.

Nonetheless, we anticipate that some employers and project financiers are likely to be concerned about an inability to contract against receivables financings at main contractor level.

One possible consequence of the Regulations therefore, could be to increase interest in direct subcontractor payment rights and/or project bank accounts. In that respect, Government policy is firmly behind such mechanisms to reduce both the incidence of supply chain payment failure and the cost of construction. Of course, the latter assumes that cashflow margins lost are not simply replaced elsewhere in a pricing model.

*What is the latest current government policy on Construct Industry payment practices?*

**Construction 2025**, the government's long-term vision for the future of the construction industry, highlights the need for certain and equitable financial arrangements and proposed a need to "...create conditions for construction supply chains to thrive by addressing access to finance and payment practices."

In 2014, the Government also launched the **Construction Supply Chain Payment Charter** (expected to be updated this year). This set out 11 fair payment commitments, including:

- (a) target payment periods (arguably overtaken by the Public Contracts Regulations 2015)
- (b) an endorsement of Project Bank Accounts
- (c) an undertaking not to impose fees or costs for receiving payment within the terms set out in the contract, where finance schemes allow members of the supply chain to obtain earlier payment.

## The Set-Off issue

Construction contract payment processes can be quite varied but, as a general rule, employers are typically keen to preserve wide set-off entitlements and contractors and subcontractors do likewise in subcontracts. Indeed, whilst UK construction legislation has regulated the process for withholding from payments, it has never sought to limit entitlements to do so and arguably enshrines these rights.<sup>3</sup> The potential risks to an employer's right to set off/withhold payments has been the other principal reason given for prohibiting assignment by contractors and is therefore an obvious area of concern with the Regulations.

Concerns were raised by the City of London Law Society, in the consultation process for the Regulations, that the issue of set-off had not been addressed by the early drafts. At the time of writing, this remains the case.

If A enters into a contract with B, and B then assigns the debt to C, there can be some fine distinctions in practice as to whether A is allowed to set off against invoices which are issued as payable to C. The starting point is fine, as an assignment of any construction contract will be subject to the 'equities' of that contract (as the assignee cannot be in a better position than the assignor) – these include, for example, rights of recovery for delay and defects.

If, however, the assignment of debts takes place ahead of any set-off rights crystallising, the set-off position becomes less clear and especially so if the contract has been varied or changed. In particular, issues may well arise where the change made is deemed effectively to create a new contract between the parties or if financial institution assignees seek to include 'no set-off' terms in their notices of assignment.

<sup>3</sup> It could be argued that it is the uncertainty of construction payment flows, including the existence of set-off rights, rather than prohibitions on assignment that has discouraged receivables financing in the construction industry.

Should the Regulations constrain or create uncertainty in relation to these rights, for example, in relation to liquidated damages or defect rectification, this could impact on employers' (and their funders') risk analysis. Arguably it could even have adverse implications for the size and nature of performance security (e.g. retention or bonding), where legitimately required on a project.

It would certainly cause issues for the unaware if an effect of the Regulations was to compromise the ability of payer entities to make withholdings and pay less when otherwise entitled to do so. It would be even more unfortunate if a further consequence of the Regulations was to be the reversal of the general thrust of policy and trends on retention and bonding, as savvy but cautious employers seek liquid security to compensate for a possible loss of set-off rights.

#### **A confidentiality escape route?**

One of the exceptions available to the Regulations is where the term prohibiting assignment gives rise to a duty of confidence. This is not further defined in the Regulations but we think it unlikely that this was intended to allow wide-scale avoidance of the Regulations by use of onerous confidentiality provisions. More likely the intention is to allow conditions to be imposed that require an assignee to accede to and observe contractual confidentiality requirements (which in themselves are probably not going to deter potential financiers from receivables financings).

#### **Avoidance/deterrence**

Given the apparent breadth of the Regulations, in particular their purported effect on English law contracts both (i) outside the UK, and (ii) within the UK between larger scale enterprises (which should arguably be free commercially to agree prohibitions on assignment), there may well be attempts to bypass the Regulations.

One seemingly obvious potential route for those seeking to deter unwanted assignments is to impose contractual consequences which will arise post-assignment. The draft Regulations only provide for the ineffectiveness of any provisions prohibiting/conditioning the assignment of a receivable in business contracts (to the extent such assignment is prohibited/conditioned). They do not appear to prevent parties from agreeing that an assignment would lead to (say) a retention right or perhaps less drastically, to an entitlement to make direct payment to lower tier suppliers and subcontractors or to use escrow and project bank account arrangements. There would be a risk that such deterrents could be construed purposively as *"a condition or other restriction on the assignment of a receivable"*, but that would require a party willing to test this question as a point of law.

An alternative avoidance route might be to utilise the Regulations' exceptions – the draft Regulations appear to only have impact on prohibitions/restrictions on assignment when these terms are inserted in contracts subject to the Regulations. Accordingly, parties to such contracts, who wish to agree prohibitions/restrictions on assignment, could instead (or, in addition) insert them in a separate excluded contract. However, it should be noted that the exceptions to the Regulations are quite limited and it may not be feasible, in practice, to make a contractor or sub-contractor party to the relevant excluded agreement solely for this purpose.

#### **Conclusion**

The Regulations have a laudable aim of increasing the ability of UK SMEs to secure receivables finance. However, the ambit of the Regulations is too wide, too uncertain and runs the risk of cutting across the principle of freedom of contract in other commercial scenarios which do not appear to have been fully considered by (and, presumably, cannot have been the intention of) its promoters.

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