

# PFI DEFECTS AND DISPUTES

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What you need to know



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An increasing number of operational PFI projects are falling subject to disputes between public authorities and project companies. Our market leading lawyers in PFI disputes have shared a few tips for successfully navigating the choppy waters.

## 1 It's all about context

PFI contracts usually constitute a significant percentage of a public authority's budget; an authority might spend 10% or more of its annual budget on the payments due under a PFI project agreement. Understandably, they therefore demand a very high standard for their money. And, with budget cuts taking their toll across all areas of government, PFI contracts are coming under increased scrutiny.

From the other perspective, project companies are special purpose vehicles with high debt repayments and are subject to stringent controls by their funders. Project companies are also under pressure to make a healthy return on their shareholders' investment. With no other sources of income or significant assets, any reduction in payment (or unexpected costs) can risk default on its loan or even insolvency.

It is important that both sides understand the pressures the other is under. A frank, constructive dialogue as soon as issues start to surface is vital to achieve a mutual appreciation of the issues and ensure a good relationship between the parties, especially in circumstances where project agreements have many years to run.

## 2 Is the problem service based or a defect in the works?

The first question for an authority to understand is what is the nature of its complaint? Is there a problem with the service provision – for instance, is cleaning being done properly? Is the building or asset being maintained appropriately? Alternatively, is the issue to do with a defect in the original construction works? The answer to this will ultimately determine what remedies are available to the authority (if any) and help inform its approach going forward.

Understanding the nature of the defects is of fundamental importance to both parties. Project companies will want to allocate any costs between its sub-contractors and understand where it is at risk. For the public authorities it's not just about understanding what its remedies are against project companies – it will also have important health and safety and operational decisions to make.

## 3 Defects – beware the 12 year rule

Increasingly, the basis of disputes is a fundamental problem with the initial construction of the building. For example, we advise on number of hospital PFIs with fire safety related problems – failings in passive fire protections such as compartmentation, dampers, and fire doors or active fire protections such as faulty alarm or sprinkler systems. Elsewhere, defects might relate to failing pipework, defective ventilation systems, or failings in walls or foundations.

However, authorities and project companies involved in older PFI projects should be wary – if the building reached practical completion more than 12 years ago, then project companies may struggle to pass deductions or costs of repairs through to the building contractor who might rely on the 12 year limitation period. Whilst it is not always that straightforward, as specific contracts may invoke additional obligations which extend the contractor's liability beyond the standard 12 years, a good rule of thumb is that any claims for construction defects become a lot more difficult after that time period.

Authorities can still claim against project companies (which usually "wraps" all the risk), but if project companies can't bring a corresponding claim against the building contractor then the project company may be at risk of insolvency - especially if it cannot pass any losses through to the FM provider either (see our comments about project companies' precarious position above). If the project company becomes insolvent, the costs of repairs – often significant in operational buildings – could fall to the authority.

## 4 Deductions – a means to an end, not an end in their own right

The payment mechanism in PFI contracts ordinarily allows authorities to make deductions from the unitary payment where there is a failing in the provision of services or original construction. This mechanism is designed to incentivise project companies to put right any failing as soon as possible, and this is how it should be viewed. Authorities might be tempted to try to alleviate budgetary pressures by hunting down service or works failures and applying deductions.

This is usually a bad idea for a couple of reasons. First, it's not sustainable. Once the problem is corrected, the payments go back up so will rarely be a long term solution to budget cuts. Second, and importantly, it is likely to create a very distrustful relationship with the project company and its subcontractors. As we will see, the strength of relationship between the parties is all-important. Finally, an over-zealous authority is at risk of misapplying the payment mechanism and making more deductions than it is contractually permitted. Payment mechanisms are complicated and it is easy to go wrong. Over-deduct and the project company may be left with little choice but to adjudicate to recover what it's owed. This can be an expensive, time consuming and fractious process which could be avoided.

## 5 Good relationships – undervalue at your peril

More often than not the best way to solve a dispute in a PFI context, where it's likely that the contract has many years, even decades to run, is by agreement. Putting a decision in the hands of a third party like an adjudicator or the courts not only costs a lot in irrecoverable expenses and management time, but adds in a significant degree of risk; even with a good case on paper adjudicators and courts can have a bad day and side against you. Crucially, the parties will lose the ability to determine their own destiny.

We are one of the leading legal advisers in PFI disputes having advised on dozens of disputes for project companies and sub-contractors, lenders and public authorities with great success. Whilst nobody wants to get into a dispute, our experience tells us that those projects where the parties have good working relationships, are able to make compromises and understand each other's perspectives are the ones where disputes are least likely to arise. And, if they do, the disputes are resolved most quickly and with least expense.

If you have a question or want to talk to us about your PFI dispute, please get in touch.



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