

CLLS CONSTRUCTION LAW PRACTICE COMMITTEE

NOTE ON ESCROW ARRANGEMENTS

1 BACKGROUND

- 1.1 This note describes the type of mechanism that is typically adopted where the Employer under a building contract agrees to place funds in escrow as security for the making of payments to the Contractor. It is not exhaustive and several variants of this model are currently in use in the market. The precise details of the arrangement in each specific case will depend on the commercial background and the particular circumstances of the transaction to which it relates. Legal advice should be sought to ensure that the project-specific documentation is legally robust and reflects the commercial intent of the parties.
- 1.2 The purpose of the escrow is to provide a fund on which the Contractor may draw in the event of default by the Employer in making payments (certified as) due under the building contract. It is typically used where the Employer is a single-purpose vehicle (SPV) established specifically for the project in question, is an overseas entity or individual or otherwise is unable to demonstrate creditworthiness and an established trading record.
- 1.3 Needless to say, the creation of an escrow will tie up funds that would otherwise be available to the Employer for use in its business. It will not therefore be suitable for all clients. Those who are unwilling or unable to set aside funds in this way may wish to consider offering alternative forms of security, such as a letter of credit, a guarantee from a bank or parent company (if one exists), a commitment from the Employer's funder to make direct payments to the Contractor or the use of a project bank account.
- 1.4 Typically, the escrow will be drafted so that it covers all sums due under the building contract. However, this will not always be the case and in some cases it may provide partial security only. For example, it may only relate to sums due in excess of a certain amount, if the Employer is considered to be of some (but limited) financial standing. Alternatively, it may cover only the second half of retention held by the Employer during the rectification period following Practical Completion.
- 1.5 The sum held in escrow will typically be fixed by reference to a forecast cash flow agreed between the parties. A common approach is to choose a sum representing the maximum predicted spend in any two month period during the works, so that the Contractor is protected not only in respect of non-payment under an interim certificate, but also for work in progress which will in due course fall to be included in the next interim application for payment. Occasionally a stepped arrangement will be adopted, under which the escrow sum is increased in line with the "S-curve" payment profile of a typical construction project. However, this is a cumbersome arrangement and is rarely used in practice. A more common refinement is for the escrow sum to be reduced on Practical Completion, at which point the Contractor's risk is limited to the second half of the retention.

2 **COMPONENTS OF THE ESCROW**

2.1 **Introduction**

There are two components to a typical escrow arrangement:

- (a) an agreement between the Employer and the Contractor supplemental to the building contract; and
- (b) a tripartite Escrow Agreement between the parties and the Escrow Agent.

The agreement between the Employer and the Contractor may take the form of a separate agreement or a series of clauses drafted into the building contract, or may be combined with the Escrow Agreement. A draft of a "combined" agreement is appended to this note. The key terms are summarised separately below.

2.2 **Agreement between Employer and Contractor**

Key features will include:

- 2.2.1 An obligation on the Employer to establish a separate, interest bearing account (the "**Account**") and to pay into the Account the agreed sum (the "**Escrow Sum**").
- 2.2.2 The Account will be ring-fenced from other monies held by the Employer, so that it may only be applied for the purposes agreed.
- 2.2.3 The Agreement will recite the purpose of the escrow, namely to provide security for the making of payments to the Contractor as they fall due under the building contract.
- 2.2.4 The Account will be managed by the appointed Escrow Agent, typically the Employer's bankers or its solicitors (acting as stakeholder). The Escrow Agent will need to satisfy itself as to the source of the escrow monies in accordance with its usual "know your client" (KYC) processes. The parties should be aware of the potential for a conflict of interest where the Escrow Agent is already retained by one of the parties (typically the Employer), since it will be minded to protect the interests of its client when setting up the arrangement as well as its own interests as escrow agent. That said, this risk can be mitigated if all parties clearly understand that the role of the Escrow Agent is purely administrative in nature. It should also be noted that there appears to be a growing reluctance amongst City law firms to act as escrow agent, both for administrative reasons and because of the KYC/money laundering issues to which it can give rise.
- 2.2.5 The Employer's interest in the monies in the Account will be stated to be fiduciary as trustee for the purposes set out in the Agreement (but without obligation to invest) until all sums to which the escrow relates have been paid. The intention behind this provision is to protect the status of the escrow monies in the event that one of the parties (including the Escrow Agent) becomes insolvent.
- 2.2.6 Any interest accruing on sums held in the Account will belong to the Employer and may be applied either to cover the Escrow Agent's administration costs (see paragraph 2.3.5 below) or to top up the Account following the making of payments out of it. Alternatively, interest may be returned to the Employer as it accrues, although this would be administratively burdensome and is rarely seen in practice.

- 2.2.7 The Employer may only withdraw sums from the Account when it is closed (see paragraph 2.2.13 below) or if the mechanism described in paragraph 2.2.14 below is used.
- 2.2.8 If the Employer defaults in making payment under the building contract, the Contractor must give not less than five working days' notice to the Employer before calling on the Account.
- 2.2.9 If the Employer continues in default, the Contractor may serve a notice on the Escrow Agent making a call on the Account. The notice must be accompanied by:
- (a) a copy of the default notice previously served on the Employer (see paragraph 2.2.8 above); and
 - (b) a certificate (purportedly signed by a director or other authorised officer of the Contractor) confirming that the sum claimed is the "notified sum" (as defined in section 111(2) of the Housing Grants, Construction and Regeneration Act 1996, as amended) and that it remains unpaid. The reference to the "notified sum" takes into account the possibility that the Employer may have served a valid pay less notice under the building contract, and may therefore be entitled to pay less than the full amount certified or otherwise claimed by the Contractor.
- 2.2.10 The Agreement will not include a right for the Contractor to terminate the building contract for non-payment as an alternative to calling on the Account. The reason is that the escrow is designed to cover the Contractor against precisely this risk and there is no need to confer on him this additional protection.
- 2.2.11 Forthwith on receiving a demand from the Contractor, the Escrow Agent must send a copy to the Employer. The Escrow Agent must then meet the demand unless, within 5 working days, the Employer either pays the amount claimed or obtains an injunction restraining the Escrow Agent from doing so.
- 2.2.12 Any payment made from the Account to the Contractor will, to that extent, operate as a discharge of the Employer's payment obligation under the building contract.
- 2.2.13 Following the making of a payment from the Account, the Employer may be obliged to top up the Account so that the balance remains at not less than the Escrow Sum. This will not always be the case and will depend on the commercial agreement reached between the parties. If the Employer is obliged to top up the Account and fails to do so – or, indeed, if the Employer fails to make the initial payment into the Account (see paragraph 2.2.1 above) - this will be treated as a failure to make payment under the building contract and will trigger a right for the Contractor to suspend work (if the contract is governed by the Construction Act) or, in an extreme case, to terminate for non-payment.
- 2.2.14 The Account will be closed on the occurrence of one of the following events:
- (a) when the purpose of the escrow has been fulfilled (i.e. all payments which it is intended to secure have been made); or
 - (b) the Contractor's employment under the building contract is terminated for any reason, and (where the termination is due to default or insolvency on the Employer's part) any payments due to the Contractor on termination have been made; or
 - (c) by agreement between the parties; or

- (d) on a longstop date, if the parties agree this; or
- (e) in some cases (depending on the commercial agreement between the parties) when the balance in the Account is first reduced to zero.

Closure of the Account will be triggered by a notice from the Employer to the Contractor (with a copy to the Escrow Agent) stating the reason for the closure. If the Contractor does not object in writing within five working days of the Employer's notice, the Escrow Agent will close the Account and return the balance of the Escrow Sum (plus accrued interest) to the Employer.

2.2.15 A refinement sometimes seen is that, once the remaining amount forecast to be due to the Contractor under the building contract is less than the Escrow Sum, any further payments to the Contractor are made from the Account, thus automatically reducing the level of security as the need for it diminishes. However, this is administratively cumbersome and is rarely used in practice.

2.2.16 The parties may agree to share between them the costs incurred by the Escrow Agent in administering the Account. In the absence of an agreement to this effect, such costs will typically be borne by the Employer.

2.3 **Tripartite Agreement with Escrow Agent**

Key features of this agreement will include the following:

2.3.1 The Employer and the Contractor jointly appoint the Escrow Agent and the Escrow Agent accepts the appointment.

2.3.2 The Escrow Agent agrees to hold the Escrow Sum (and any top-up monies) in the Account to be applied in accordance with the terms of the Escrow Agreement.

2.3.3 The Employer irrevocably instructs the Escrow Agent to comply with any apparently valid demand made by the Contractor which is accompanied by copies of the documents identified in paragraph 2.2.9 above. The Escrow Agent is not required to investigate whether the demand is in fact justified.

2.3.4 The Escrow Agent is not required to investigate the market in order to secure the best rate of interest available on the Escrow Sum, but must apply any interest accruing to the Account in accordance with paragraph 2.2.6 above.

2.3.5 The Escrow Agent will be entitled to recover its costs incurred in administering the Account, either by way of deduction from sums held in the Account, or alternatively as a debt from the Employer. The Employer and the Contractor may then agree to share the costs between them, if that reflects their commercial bargain.

2.3.6 The Escrow Agent will close the Account when instructed by the Employer to do so (see paragraph 2.2.13 above) and return any outstanding balance to the Employer.

2.3.7 There will be a right for the Escrow Agent to resign or be removed by the parties, subject to suitable arrangements being made for a successor to be appointed in its place. The parties may wish to exercise if this right if (for example) the Escrow Agent becomes insolvent, undergoes a change of control or commits a material breach of its obligations, or if they have otherwise lost confidence in its ability to fulfil the role.

2.3.8 The Employer and the Contractor will be prohibited from assigning the benefit of the Agreement without consent. Note however the potential impact (when they

come into force) of the Business Contract Terms (Assignment of Receivables) Regulations 2017, which may outlaw any proposed restriction on the Contractor's ability to assign its rights under the Agreement. Where the Employer obtains bank funding for the project, the funder may also seek to take security over monies in the Account, although this will not usually be appropriate given their trust status (see paragraph 2.2.5 above).

2.3.9 The Agreement will include various other provisions for the protection of the Escrow Agent, including:

- (a) where the Escrow Agent is a firm of solicitors, a statement that it will not be responsible for the actions of the bank in which the Account is held, including any delays in payment;
- (b) a confirmation that the Escrow Agent is not bound by, nor deemed to have notice of, the terms of the building contract, other than the escrow arrangements themselves;
- (c) a right to take legal action (at the cost of the other parties) to resolve any uncertainty as to its obligations and responsibilities;
- (d) an indemnity for any costs and losses it incurs arising from its appointment as Escrow Agent, excluding any losses resulting from its own wilful default or fraud; and
- (e) an exclusion of liability for any failure of performance due to matters beyond its control.