BUILDING & CONSTRUCTION

Security of payment reforms miss the mark on multi-tiered projects

By JESSICA RIPPON *and* ANTOINE SMILEY

New security of payment reforms mean practitioners will need to understand how each participant in the project will be characterised under the Act.


Jessica Rippon and Antoine Smiley are senior associates at Corrs Chambers Westgarth.

The construction industry in NSW is bracing itself for a number of reforms to the *Building and Construction Industry Security of Payment Act 2010* (the Act) expected to commence this month.

A primary purpose of the reforms is protection of subcontractor interests against insolvency and questionable payment practices of head contractors, with a central feature being greater control over head contractors and serious consequences (including criminal sanctions) if those controls are not adhered to.

When the reforms commence, an important consideration for contractors will be to identify the 'head contractor', as defined in the Act. Practitioners may be surprised to discover that the contracting party typically recognised in the industry as the head contractor may not in fact be considered the same under the Act.

Intent of reform

When the Collins Inquiry was announced in 2012, several high-profile construction companies were in the midst of corporate collapse: Kell & Rigby followed by St Hillier's, Hastie Group and Reed Constructions, to name a few. Further collapses occurred after the inquiry commenced, such as Southern Cross Constructions, Walton Construction and Steve Nolan Constructions.

Although head contractors are typically engaged with single point responsibility to deliver a project, the inquiry found that 80 to 90 per cent of construction work is performed by specialist subcontractors.[1] Subcontractors are therefore the most vulnerable when the head contractor either refuses to pay or becomes insolvent. In the case of insolvency, subcontractors are often left with a few cents in the dollar, if anything.[2] This is one of the reasons the Collins Inquiry focused on safeguarding interests of small subcontractors against the prospect of head contractor insolvency, while simultaneously protecting them against (what was alleged to be) the widespread practice of payment avoidance tactics utilised by head contractors.

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Targeting head contractors

The reforms that specifically target the head contractors are:

☐ No endorsement on payment claims: Except for payment claims made under certain exempt residential building contracts, payment claims will no longer need to state that they are made under the Act in order to attract its operation. This reform stems from the Collins Inquiry finding that subcontractors were reluctant to use the Act for fear that head contractors would not award them future work.

☐ Supporting statements: Head contractors will be required to provide a statement with each of their payment claims, confirming that all subcontractors have been paid. Failure to provide the statement or knowingly providing a false or misleading statement will be considered an offence. This reform was introduced to stop the practice of head contractors allegedly providing untruthful statements that subcontractors and suppliers had, in fact, been paid.

☐ Retention monies trust: Head contractors will be required to deposit subcontractor retention monies into a separate trust account.[3] This reform responds to the finding of the inquiry that head contractors were routinely refusing or failing to return retention money to subcontractors. Where bonding is provided instead of retention, no trust account will be set up. This may result in increased reliance on bonding in preference to retention. Such a measure would likely increase the cost of the project and separately defect the purpose of the reforms. It is also proposed that the regulations will provide for retention money to only be released from the trust account on consent of both parties or by order of an adjudicator or a court.[4] For head contractors, this is likely to erode the benefit of retention money as performance security, particularly where such security is intended to be available to the head contractor pending final determination of a dispute regarding incomplete, defective works or other such failures to perform.

☐ Maximum payment terms:

Head contractors (as well as subcontractors) will be required to adhere to payment terms of no more than 30 business days. Head contractors will however, benefit from a new requirement that principals pay head contractors on terms of no more than 15 business days. Any contract provision with longer payment terms will be void and unenforceable. This reform seeks to eliminate onerous payment terms, which have become prevalent in the industry.[5] It will be interesting to see how this can be achieved as between subcontractors where there are often multiple layers of contracting.

Identifying the head contractor

Given the significant consequences of non-compliance with the reforms, it is imperative that, in each case, practitioners and their clients correctly identify which party is the principal and which is the head contractor.

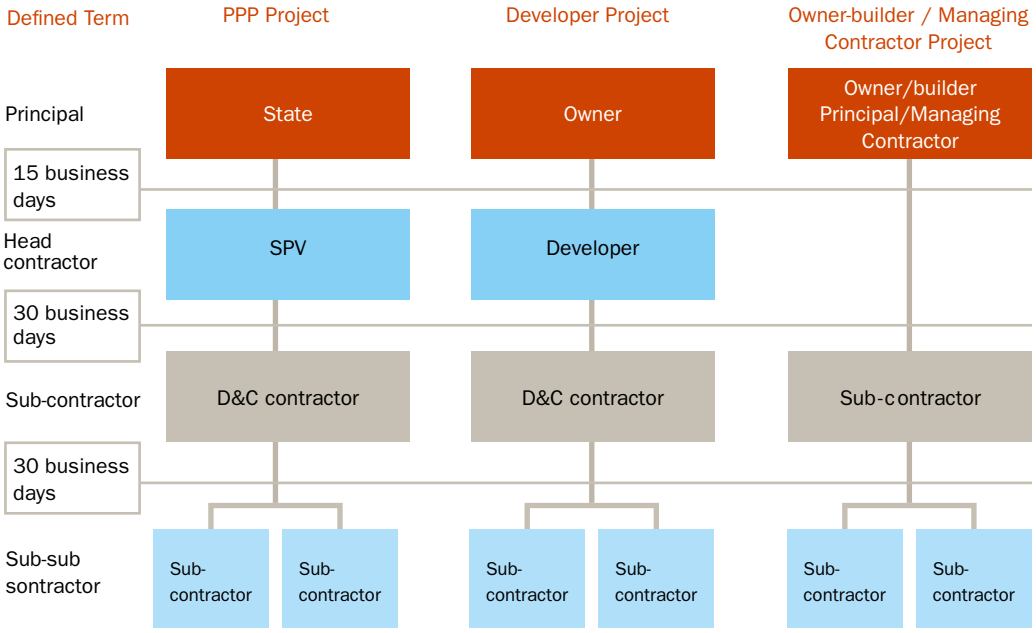
Previously, the position of parties in the chain of contractual relationships did not matter. However, the focus of the reforms has resulted in delineation between 'principals'[6], 'head contractors'[7] and 'subcontractors'.[8]

At first glance, the defined terms seem consistent with industry usage and in a simple three-tiered contracting scenario, they should operate as intended. However, a significant number of major construction projects have additional layers of contractual relationships. In these more complex project structures, the Act's defined terms raise questions about their application. This issue is best demonstrated by considering three examples of common project delivery models that account for a considerable value of projects undertaken.

Public private partnerships

In a Public Private Partnership, design and construction obligations will typically be passed down from the state government to a special purpose vehicle (SPV) made up of a consortium, including financiers and the design and construct (D&C) contractor. The SPV will then engage the D&C contractor to deliver the project, who, in turn will engage a number of specialist subcontractors through back-to-back pass through contracts (see figure 1).

FIGURE 1: EXAMPLE OF MORE COMPLEX PROJECT STRUCTURES



It is the clear intent of the reforms is to protect specialist subcontractors by imposing the reform burdens on the D&C contractor.

However, when the Act's definitions are applied to this project structure, it becomes apparent that:

- the state could be regarded as the principal under the project agreement, because it is "the person for whom work is being carried out" and "is not themselves engaged under a construction contract to carry out construction work";
- the SPV will then become the head contractor because it is "the person who is to carry out construction work ... for the principal" and "for whom construction work is to be carried out"; and
- the D&C contractor will instead become the subcontractor because it is "a person who is to carry out construction work" under a construction contract "otherwise than as a head contractor".

It then follows that the true subcontractors, those at the fourth tier of the contracting chain, will not be considered to be contracting with the head contractor and consequently, will not receive the full benefit of the reforms.

It is unlikely that the reforms intended to impose the obligations of a head contractor on an SPV, and protect the large construction organisations that typically form the D&C contractor on such projects.

In addition, SPVs may now be required to provide a supporting statement, confirming that the D&C contractor has been paid, with failure to do so constituting an offence. Even stranger, is the fact that the SPV will be under an obligation to deposit retention money of a D&C contractor in a trust account. This will seldom occur in any event, given that bonding is preferred over retention money in the larger D&C contracts.

Property development projects

This same issue will likely arise on property development projects where a landowner engages a property developer to build and develop its land and the developer will engage a D&C contractor (not uncommonly a company related to the developer). As shown in figure 1, with the addition of a developer in the contracting chain, the D&C contractor now becomes a subcontractor. The reform burdens again appear to miss their mark, falling on the developer instead of the D&C contractor.

Consequently, in this style of project contracting, the subcontractors, suppliers and designers engaged by the D&C contractor are left unprotected in so far as the D&C contractor is not required to provide a supporting statement or deposit subcontractors' retention money into a trust account.

Managing contractor and owner-builder contracts

A further issue may arise where a principal engages subcontractors directly or through a managing contractor (who might engage subcontractors as agent for the principal).

The legislation anticipates this scenario in the "notes" under the definitions of "principal" and "subcontractor".[9] However, given that "notes" do not form part of the Act, the question is whether a subcontractor might unintentionally become a head contractor under the Act if or when it engages sub-subcontractors.

The intent of the Act is that there is only one principal, one head contractor and potentially multiple subcontractors. In our view, the intent of the Act is sufficiently (but certainly not clearly) apparent in the definitions by the

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contrasting use of the definite and indefinite articles, where a principal is 'the' person that contracts with a head contractor who is 'the' person who contracts a subcontractor who is 'a' person that carries out construction work otherwise than as head contractor. In a claimant-friendly forum, this argument may have some chance of success, at least until a court determines otherwise.

Given the complexity of these projects, some confusion and disagreement may arise about which party is which under the Act, particularly if scopes of work are split across more than one D&C contractor or a managing contractor transforms into a D&C contractor during later phases of the project.

Conclusion

With the looming commencement of the new reforms, it is important that contractors and principals understand how each participant in the project will be characterised under the Act. In doing so, one must not think in terms such as head contractor according to their common industry meaning.

In NSW, significant construction work is undertaken under complex project structures and sophisticated supply chains, including those mentioned above. Looking ahead, the Sydney International Convention, Exhibition and Entertainment Centre Precinct PPP, North West Rail Link PPP and Northern Beaches Hospital PPP are a few examples of large scale multi-tiered projects that have, or will commence shortly. Any contract for construction work entered into after commencement of the reforms may be the first to encounter the issues we have canvassed.

It is unclear to what extent these issues can be mitigated through the regulations, however, there does not appear to be much scope to do so given the definitions in the Act are now fixed. In 2015, the government has promised to undertake a full and comprehensive review of the Act and its operation. This may be the first opportunity for these definitions to be revisited to accommodate complex project structures and improve the effectiveness of the reforms across the NSW construction industry. □

ENDNOTES

1. *Collins Inquiry Report*, p.12, citing Australian Procurement and Construction Council Inc. (APCC), "National Action on Security of Payment in the Construction Industry in Australia – Adelaide 1996", APCC Canberra ("1996 APCC National Action Report"), p.2.
2. See, for example, Administrators' Reports by PPB Advisory on its website *www.ppbadvisory.com* for: (a) Kell & Rigby, 22 March 2013, p.15 (b) Hastie Group, January 2013, p.28; and (c) Reed Constructions, 1 March 2013, p.1. Note also the Inquiry's finding that more than 92 per cent of unsecured creditors in the NSW construction industry were left with a zero dividend from collapses in 2011/2012.
3. See Discussion Paper released by the Department of Finance and Services in November 2013, "A statutory retention trust fund for the building and construction industry", which outlines a proposed retention trust model to be set up under the Regulations.
4. See for example, the *Collins Inquiry Report* findings at p.72.
5. Ibid.
6. Principal is defined as "the person for whom construction work is to be carried out or related goods and services supplied under a construction contract (the main contract) and who is not themselves engaged under a construction contract to carry out construction work or supply related goods and services as part of or incidental to the work or goods and services carried out or supplied under the main contract".
7. Head contractor is defined as "the person who is to carry out construction work or supply related goods and services for the principal under a construction contract (the main contract) and for whom construction work is to be carried out or related goods and services supplied under a construction contract as part of or incidental to the work or goods and services carried out or supplied under the main contract".
8. Subcontractor is defined as "a person who is to carry out construction work or supply related goods and services under a construction contract otherwise than as a head contractor".
9. Principal: "There is no head contractor when the principal contracts directly with subcontractors." Subcontractor: "A subcontractor's contract can be with the head contractor or (when there is no head contractor) with the principal directly." □