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Security of Payments - A new answer to an old question

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Introduction

The *Building and Construction Industry Security of Payment Acts* (the Acts)[1] now in force in most States are causing a radical re-think of many traditional project management and contract management processes. The Acts apply to every business involved in Building and Construction including contractors, subcontractors, clients, suppliers and professional firms.

However, the consequences and impact of these Acts is far from certain and little understood in the general community (with the possible exception of NSW). The first part of this paper will provide a brief overview of the functions of the Acts. The middle part will look at the current state of uncertainty surrounding the interpretation of the Acts. The final part will look at some of the issues and risks facing professional service providers in the construction industries where the Acts apply. In conclusion we will suggest some potential options open to construction industry professionals to address and manage the impact of the Acts on projects in which they are involved.

The Acts vary from State to State and have been subject to rapid clarification and change as various issues and matters are brought before the Courts. Consequently, this paper is only intended to provide a general overview of some aspects of the Acts. Independent legal advice should be sought before relying on anything contained herein or any action is taken in relation to the matters described herein.

The Purpose of the 'Securities of Payment' Legislation.

The purpose of the *Building and Construction Industry, Security of Payment Act,* in each of the jurisdictions in which it has been enacted, is to facilitate the prompt payment of monies owed under a construction contract. Where a dispute exists as to the amount due to be paid, the Acts provide for the appointment of an Adjudicator to assess the monies to be paid, the due date for payment and any interest that may accrue. The process is designed to be just, quick and cheap, focusing on maintaining cash flows.

Any payment made under the Acts is a provisional payment on account (similar to an interim progress payment under most building contracts). In general terms, any monies due to be paid pursuant to a claim under the Acts, must be paid within a very short and defined timeframe. However, the Acts do not prevent the final resolution of the matters in dispute at a later date by whatever means is appropriate under the terms of the contract[2].

The scope of the Acts is very wide reaching. Almost any work associated with any form of engineering or building construction including temporary works, materials supply and

professional services is covered. There are three significant exceptions to this general coverage. The first is works performed by a builder for an 'owner occupier (i.e. domestic building works). However, whilst the builder cannot use the Act to claim monies from the 'owner occupier', this exception does not extend to the builder's subcontractors and suppliers who are entitled to use the Acts to claim monies owed from the builder. The second major exception is financiers. Builders and others cannot use the Acts to claim money from the banks and finance companies that may be funding a project. The third exception is mining and mineral extraction activities although the line between construction (eg building a processing plant or construction a haul road) and actual mining has yet to be considered by the Courts.

The key provisions of the Acts can be summarised as follows:

- The Acts define the organisation or person making the claim as the Claimant, and the organisation or person who has to respond to the claim (by paying monies or defending the claim) as the Respondent.
- The Acts void any contract provisions that seek to modify, restrict or exclude the operation of the Act. This means no one can contract out of the Act[3].
- The Acts apply to all forms of contract including verbal agreements[4].
- Pay-when-paid provisions are now unenforceable[5].
- If the contract does not make specific provisions for progress payments, the Acts create a statutory right to regular progress payments[6].
- The Respondent is required to respond to a claim under the Act by producing a payment schedule (typically within 10 business days). If a payment schedule is not produced, and/or payment is not made within the statutory time frame (typically 2 days), the Respondent becomes liable for the full amount claimed.
- If the Claimant is not satisfied with the payment schedule, it can instigate Adjudication provided this action is started within the period specified by the relevant Act[7].
- Appointing an Adjudicator will usually take a few days. Once appointed, the Adjudicator has 10 business days to reach his or her determination[8].
- The Adjudicator's determination is final and enforceable. In general terms, this means the Adjudicators determination cannot be appealed and is allowed by law to contain errors.
- Monies due as a consequence of a Payment Schedule or Adjudication determination can be recovered in the relevant Court as a debt owing (the rights and powers to do this vary from State to State)[9].
- When monies are not paid in accordance with the Act, the Claimant can suspend works (without being in breach of contract) until such time as the payment is made[10].

Claims under the Acts have ranged from a few hundred dollars to values in the order of $33 million. Whilst there have been a number of appeals against Adjudicator's determinations, particularly in NSW, overall the success rate has not been very high The few successful appeals have tended to be in the areas of jurisdiction (where the Adjudicator has been found to have exceeded the authority granted by the Acts) and procedural fairness (where the Adjudicator has been found to have breached the rules of natural justice, bias or failed to follow the requirements of the Acts)[11].

Generally, the Courts have been unwilling to consider or review matters relating to the quantum and/or accuracy of the Adjudicator's calculations. Without exception, the Courts have enforced all of the time limits contained in the legislation. In particular, Respondents that failed to produce payment schedules in the requisite time frames have been unable to avoid Judgments being recorded against them for the amount claimed. The largest single amount being some $14 million awarded to the Walter Construction Group in Sydney against CPL (Surrey Hills) Pty Ltd[12].

Uncertainty Surrounding the Interpretation of the Acts

The intention of the Acts is relatively simple and straightforward; it is to provide **a** right to regular progress payment and a mechanism for defining a 'reasonable' amount to be paid for each progress payment. However, being very new law, the full scope and impact of the Acts has still to work its way through the legal and business systems.

In general terms, Parliament makes the law and the Judiciary interprets and applies the law. Within this process 'interpretation' can extend to effectively creating new law by limiting or extending the effect of various provisions within an Act. The driving force for this process is the doctrine of precedence which requires that like cases be decided alike. Where the earlier decision has been made by a superior Court, the precedence is binding, where the decision has been made by a Court in another jurisdiction or by a Court of equal or lower standing, the earlier judgments are persuasive. Overlaying the above are matters of 'public policy' (ie general guidelines) that the Judiciary see as being important.

In areas of established building and construction contract law, the above process provides a relatively high level of understanding and certainty as to the likely outcome of any dispute and has allowed forms of contract to be developed that modify general legal principles.

A typical example is penalty payments. Generally, the law does not recognise penalty payments for a breach of contract and these cannot be enforced. However, damages (i.e. actual loses) can be recovered for a breach of contract. Because of the difficulty of proving actual losses caused by late completion on many building projects (eg what is the actual loss suffered by a Municipality caused by the late completion of a public road?), building contracts have developed over the years to incorporate the concept of 'Liquidated Damages' (LDs). LDs are effectively a penalty paid by the builder to the Principal for late completion. However, provided the LDs are dealt with properly during the formation of contract they are enforceable and the actual losses do not have to be proved. The leading judgments in this area of law date from the mid 1800s.

The 'Security of Payment' legislation does not have this type of history to draw on. The NSW Act has been in force for less than six years and has already had one major revision with another completed. The Victorian legislation has been in force since 2003 and is currently being reviewed. As a consequence, very little case law has been established. Despite the NSW building industry and Courts making heroic efforts to rectify this deficiency, with new judgments being handed down on an almost weekly basis, many areas of the law still remain untested in the courts.

More importantly, very few of the standard forms of contract have been modified to deal with the implications of the Act. General contracts and subcontracts frequently have requirements for certifications, etc, that differ from the legally imposed obligations under the Acts. Similarly, terms of engagement for professionals rarely consider the impact of the Act on their workloads and schedules.

Whilst a claim under the Act is made against and must be delivered to the Principal and progress claims are generally delivered to the Superintendent, practice in NSW at least has seen normal monthly progress claims forwarded to the Superintendent under the contract and at the same time served on the Principal under the Act. Consequently, the Principal needs the Superintendent to assess the claim and provide that assessment to the Principal well within the 10 days allowed by the Act so the Principal can respond with a payment schedule within the time allowed. However, many construction contracts allow the Superintendent up to 14 (or even 21) days to make an assessment and many service contracts used to appoint Superintendents, quantity surveyors, etc, do not require any specific actions as a consequence of claims made under the Acts.

The Acts have changed the administration processes within the building industry significantly and permanently. Whilst at the time of writing, it is uncertain what obligations and liabilities the Acts in various States will effectively place on various building industry professionals as a 'duty owed' to their Principal, it is clear that the professions will need to adapt to survive. Some of the potential risks and issues are discussed below.

Issues and Risks Facing Professionals in the Construction Industry

The term 'Professional' is used in this paper to include most businesses and people involved in the provision of administrative services to a Principal. This can include Project Managers, Architects, Engineers, Quantity Surveyors, Contract Administrators, Accountants and Lawyers.

The first area of exposure is the simple fact that subcontractors and suppliers working for the Professional provided they are working under a commercial contract (ie are not working under an employment contract) and are supplying goods and/or services for use on a construction project have recourse to the Act and can use it to obtain progress payments. Similarly, the Professional can use the Act to seek payment of its fees.

Of greater concern is the impact of the Act on the Professional's services. Prior to the introduction of the Acts time was available to 'clean up' contract administration problems and deal with any open issues in the lead up to a dispute. Documents could be found, reports gathered from Experts and a considered position adopted. Typically many months (occasionally years) would pass between the start of a dispute and its final determination by an Arbitrator or Judge.

Now, a Respondent has just 10 business days to recognise a claim has been made under the Act; and then to prepare, settle and issue a payment schedule dealing with everything raised in the claim. Shortly thereafter (if an Adjudication is instigated), the respondent needs to complete an adjudication response and the Adjudicator makes an award that is enforceable in the Courts.

The exposure of the Professional if its client loses an Adjudication and has to make a significant payment to a Claimant is a very open question. In practical terms, the Professional needs to be able to provide the Respondent (Principal) with a draft assessment of the whole claim within 3 working days, this allows three days to fill in any gaps and three days to settle the payment schedule (ie for the Principal to decide on its response). The tenth day is needed for copying and delivering what is usually a major payment schedule.

Common sense suggests the quality of the response to a major claim lodged under the Act cannot be anywhere near as good as a similar document prepared for Court or Arbitration, the available time is simply inadequate (10 days verses 10 weeks or even 10 months). What is undecided is what standard of documentation from the Professional is adequate or appropriate? Obviously if the Principal is largely successful, rough enough is good enough, but what if the Claimant is largely successful? How liable is the Professional?

Similarly, difficult variations claims, Extension Of Time (EOT) claims and the like have often been left to be sorted out later in a contract (usually around the time of practical completion or the final claim). The Professional and the contractor focus on building the project. Now the contractor can spend significant time preparing a claim, obtaining expert reports, etc and when completely ready, lodge a claim under the Act on the Principal. The Principal has 10 days to respond, what liability is placed onto the Professional to have a considered position, properly documented? Particularly if the mater that is being claimed is several months old? Doyles Construction Lawyers have worked with a Principal faced with a claim under the Act for $16 million containing over 200 variations claims. We still only had the statutory ten days to respond.

This raises another question; the fees charged by Professionals are based on traditional workloads. Who covers the overtime and weekend work needed to develop a Payment Schedule for a major claim? In a hotly contested contract it is possible to see progress claims and claims under the Act delivered every month. Every claim requires a schedule and the normal contract payment processes need to be honoured. From the Professional's perspective this can virtually double the workload.

Several Adjudication determinations in excess of $10 million have been made to date. If nothing else, these payments have placed a significant strain on the respondent organisation's cash flow. Whilst the Adjudicator's determinations are by definition only interim in nature (a payment on account), in these situations it is the respondent (not the claimant) that has to seek a final settlement of the issues in dispute under the normal provisions of the contract. If a client has outlaid several millions of dollars in respect of 'lost' Adjudications and is experiencing difficulty recovering monies from the Claimant, how exposed are the Professional advisers (and their Professional Indemnity (P1) insurers)?

Finally, whilst financiers cannot become Respondents under the Act, they are not immune from the effects of the Act. Many developers operate on reasonably limited financial

reserves. Under the old regime, the value of work done, draw downs from the financier and payments to the contractor and subcontractors were reasonably predictable. If disputes arose, many months would elapse before payments needed to be made. Now a developer may suddenly be liable for a payment of $10 million as consequence of an Adjudication determination. This amount could significantly exceed the value of work done on the project to date and be beyond the capacity of the developer to pay.

Whilst the payment is interim and can be recovered through normal legal processes, the litigation or arbitration will take months. This places the financier in (to say the least) an interesting position. Withhold the funds and see the project and developer fail? Pay in excess of the value of work completed, keep the developer afloat and seek recovery from the Claimant (difficult without specific contractual provisions, particularly given the issues surrounding privity of contract — the financier has a contract with the developer not the Claimant)? Or perhaps seek redress from the Professionals that failed to properly respond to the Claim?

We predict over the next few years, many of these issues will come before the Courts and define the approach to be adopted. We can confidently predict that the liability and responsibility of the Professionals in the building industry has changed substantially, as has the risk profile for financiers and insurers.

Review of Recent Cases and Their Implications for Professionals

Recent cases have highlighted the pressures on professionals to comply strictly with the requirements of the Act. In *Vince Schokman & Anor v Xception Construction* [2005] NSWSC 297, Xception served a payment claim on Schokman, but Schokman did not respond with a payment schedule. Xception then provided a notice of intention to apply for adjudication, however this notice was sent outside the 20 business day period required by the Act. The Court found that Xception's notice was out of time and that they could not validly proceed to adjudication.

In addition to an understanding of the provisions of the Act, Professionals will also need to acquaint themselves with how those provisions have been interpreted by the Courts. In *Okaroo v Vos Construction* [2005] NSWSC 45, the Court held that arrangements between the parties do not need to be legally enforceable in order for claimants to exploit the Act. Consequently, Professionals acting for parties should ensure that all agreements are documented and informal arrangements are restricted to minor obligations.

In *TQM v Dasein* [2004] NSWSC 1216, Dasein said that an adjudication application was given to TQM by a courier, who had left the envelope at the rear door to TQM's principal place of business, after receiving no response at the front door of the premises. The Court concluded that the requirement of "receipt" under the Act, is defined as "taking into one's possession" and is not the equivalent to "being served" or "having been served". Consequently care should be taken to ensure that the adjudication application is actually received.

In *Barclay Mowlem v Tesrol Walsh Bay* [2004] NSWSC 1232 the Court dealt with the matter of whether a payment schedule had within the meaning of the Act been "provided". The Court held that to "provide" a payment schedule means at least that the process of delivery must be initiated by the respondent (such as by posting or handing to a courier)

rather than the actual receipt of the payment schedule by claimant. Professionals should therefore make sure that adequate procedures are in place to ensure that administrative tasks arising from the Act, such as the sending or receiving of documents, are adequately monitored, recorded and controlled, as simple administrative errors or oversights could have costly consequences for the parties they represent.

In *Alan Connolly v Commercial Indemnity* [2005] NSWSC 339 the Court considered whether three invoices served together can be regarded as one payment claim. The Court clarified that whist the Act prohibits "more than one payment claim in respect of each reference date", a payment claim may be constituted by several documents served at the same time. However, multiple documents may not constitute a valid payment claim. Professionals should therefore take care to ensure that the form of the payment claim is clear.

Also, the Courts have held that an adjudicator's determination is not void because the adjudicated amount included an amount "for" construction work including delay damages and interest: *Coordinated Construction v J M Hargreaves* [2005] NSWSC 312. Clearly, therefore, Professionals charged with the assessment of payment claims, must be in position to quickly address matters such as extension of time and damages, and can no longer put them to one side for consideration at a later date, as was previously the case. It is now clear that adjudicators will have little sympathy for a party if it is ill-prepared, even if the claim involves large sums and complex issues. The Courts have confirmed that the policy of the Act is "pay now argue later" and as such the Court is unlikely to interfere and grant an injunction unless the adjudicator's determination is fatally flawed: *Australian Remediation Services v Earth Tech Engineering* [2005] NSWSC 362.

It is evident from these recent cases that in matters relating to the Act, parties, including Professionals acting on their behalf, could suffer considerable disadvantage and possibly sever financial consequences, if they fail to understand and adhere strictly to the duties and requirements imposed on them by the Act. Undoubtedly, principals will look to their agents to obtain guidance as to their risks and responsibilities under the Act. Any default by those agents in providing adequate advice and services, will obviously expose them to claims of compensation from principals.

Conclusions and Recommendations

Claimants need to consider the overall implications of taking action under the Securities of Payment Acts. We suggest it may be prudent to use the Act as a powerful negotiating tool and be flexible in its application as and when necessary.

Respondents must assume every claim that purports to be made under the Act is serious and respond appropriately. Failing to prepare a payment schedule equates to accepting the claimed amount, whether that amount is reasonable for the work performed or not.

All Professional contract administrators must manage every aspect of a contract on the assumption that all outstanding variations will be included in a claim under the Act in the next month. It is no longer acceptable to let variation claims (including EOT claims) remain unanswered.

Construction industry Professionals need to look at their terms of engagement and PI insurance policies.

Principals and agencies that draft construction contracts need to look closely at the provisions of the Acts and wherever possible align internal contract timeframes and obligations with the timeframes and obligations imposed by the Act.

Finally, become friendly with your neighbourhood construction lawyer. The legal landscape surrounding the Act is changing rapidly and is different in every State where a version of the Act has been proclaimed. Staying abreast of the changes requires significant ongoing effort. Stability and consensus will eventually develop, however, this is likely to take several (many) years, in the meantime we are all dealing with a new and uncertain reality.

An ancient Chinese curse is 'may you live in interesting times'[13] we suggest the current times are exceptionally interesting for construction administrators and Professionals. Those that survive and prosper will be those that adapt best to the new environment.

References

Updates on key aspects of case law affecting the application of Security of Payments legislation and Adjudication can be found in the 'Casewatch' section of our web site at www.doylesconstructionlawyers.com

[1] Current Acts:

Vic: *Building and Construction Security of Payment Act 2002* (currently being reviewed)
NSW: *Building and Construction Security of Payment Act 1999* (amended 2002)
Qld: *Building and Construction Industry Payments Bill 2004*
WA: *Construction Contracts Bill 2004*

[2] See sections 3(4) and 47 of the Victorian Act, sections 3(4) and 32 of the NSW Act, sections 5 and 100 of the Queensland Act and section 53 of the WA Bill.

[3] See section 48 of the Victorian Act, section 34 of the NSW Act, section 99 of the Queensland Act and section 53 of the WA Bill.

[4] See section 7(1) of the Victorian and NSW Acts, section 3(1)(a) of the Queensland Act and section 7(2)(a) of the WA Bill.

[5] See section 13 of the Victorian Act, section 12 of the NSW Act, section 16 of the Queensland Act and section 9 of the WA Bill.

[6] See section 9 of the Victorian Act, section 8 of the NSW Act, section 12 of the Queensland Act and section 15 of the WA Bill.

[7] See sections 16-18 of the Victorian Act, sections 15-17 of the NSW Act, sections 19—21 of the Queensland Act and sections 25 and 26 of the WA Bill.

[8] See section 22 of the Victorian Act, section 21 of the NSW Act, section 25 of the Queensland Act and section 31 of the WA Bill.

[9] See Oxbara Pty Ltd & Stellavare Pty Ltd v Geotech Pty Ltd [2002] ACTSC *116*

[10] See section 29 of the Victorian Act, section 27 of the NSW Act, section 33 of the Queensland Act and section 42 of the WA Bill.

[11] See Musico & ors v Davenport & Ors [2003 NSWSC 977, Brodyn Pty Ltd t/as Time cost & Quality v Phillip Davenport& Ors NSW SC 1019, and Abacus v Davenport & Ors [2003] NWSC 1027.

[12] See Walter Construction Group v CPL (Surrey Hills) Pty Ltd [2003] NSWSC 266.

[13] In a speech in Cape Town, South Africa, on June 7,1966, Robert F. Kennedy said, "There is a Chinese curse which says, 'May he live in interesting times'." An earlier reference (as quoted) is in the science fiction story "U-Turn" by Duncan H. Munro, published in the April 1950 issue *of Astounding Science Fiction.* This 'Chinese curse' has puzzled Chinese scholars, who have only heard it from Americans! It may be related to the Chinese proverb, "It's better to be a dog in a peaceful time that be a man in a chaotic period."

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