

## Security of Payment

- 
- **Bob Giles, Chair, CIDA Security of Payment Action Team; Manager, Contracts Branch, Legal and Contractual Division, Queensland Administrative Services Department.**
- 

**This article is based upon an address given by the author to the CIDA National Conference in May 1995. It provides a summary of the current position around the country on security of payment.**

It is important to firstly return to the genesis of the Security of Payment Action Team's mission. The Construction Industry In-Principle Reform and Development Agreement included in its objectives for:

"The introduction of commercial performance standards for construction and registration of pre-qualified contractors; rationalisation of contractual relationships, especially the allocation of risk between the parties."

The priorities for changes to contracts and procedures included:

- a. quality of management;
- b. registration/selection of contractors/consultants;
- c. delivery systems;
- d. security of payment.

At all times the Security of Payment Action Team and finally the CIDA Board has sought to provide initiatives which are founded on establishing "best practice" solutions and which meet these objectives.

Security of Payment is a complex problem, it does not have a single cause, there is no single or simple solution. It was also evident that to focus on subcontractors alone was not appropriate. Payment problems of course can affect any party in the chain. CIDA's response to this challenge has been to develop a series of interlocking recommendations that attempt to address the many practices of the industry that contribute to the problem.

It was evident that we must attack the underlying cause of the problem not treat the symptoms. For example insurance is an easy answer but it does nothing toward improving our industry by eliminating the cause of the non payment problem in the first instance.

Accordingly, the Team's recommendations fall into a number of categories:

- those that suggest cultural change - a better way of doing things;
- those that authorities through their existing legislation and regulation can assist;
- those that ensure safeguards through tender and contract conditions; and
- those that seek to outlaw unacceptable practices.

### Final Recommendations

The action team submitted 35 recommendations to the CIDA Board and over two board meetings, it reshaped a number to reflect a "best practice" approach and rejected two of the recommendations.

The following is a broad summary only of the final recommendations:

There are 4 recommendations concerning corporate governance which included working on a number of fronts with the Australian Securities Commission to develop educational programs to improve industry's knowledge of corporations law and to attempt, through relevant licensing authorities, to bring uniform criteria to licensing among those who presently licence.

There are three recommendations concerning project funding. These are fairly controversial but nevertheless are seen to be important by the Action Team. They seek to give tenderers and the contractor some assurance that funding for a project is available and in place both prior to call of tenders and again at contract formation.

There are two recommendations concerning financial evaluation and centered around the requirement for any party to have access to the financial capacity and viability of those with whom they are contracting and requesting CIDA to enhance the PQC by providing assessment tools in this regard. There was also seen the need for all parties to have management and financial skills training and to be able to understand the need for working capital, balance sheets, resource planning and business planning.

There are five recommendations concerning tendering. Firstly all parties were encouraged to adopt the Australian Standard Code of Tendering and the Australian Standard Code of Ethics and Procedures for the Selection of Consultants. The Action Team and the Board recognised that the current level of bid shopping was not conducive "for the development of an internationally competitive construction industry requiring all parties at every stage of the process to protect the integrity of the tendering system. Accordingly the Principal is encouraged to require tenderers to name or at least provide a selection of names of proposed subcontractors for major trades". Appropriate amendments

to the various tendering codes were also drafted.

There are 12 recommendations concerning contractual provisions. The main thrust here is firstly proof of payment and this is not statutory declarations. The recommendation envisages a signature on a piece of paper indicating that payments due and owing have been received. Secondly that industry standard form contracts be used for head contracts with mandatory use of back to back subcontract conditions. Also included were the outlawing of "pay-if-paid" payment clauses, an equitable allocation of risk, a limiting of amendments to standard form contracts, a right for all parties to suspend for non payment and elevation and ADR mechanisms for dispute resolution.

There are three recommendations concerning administration of the contract including the use of electronic funds transfer for payments and the enforcement of the right to be promptly paid in progress payments for variations and claims.

Lastly there were four recommendations concerning security under the contract. Another essential plank here is that cash securities and retention monies should be held in trust. Also included are recommendations in respect of management or agency type contracts to the effect that payments to trade contractors be held in trust. Notably the Board made no recommendations in respect of security bonds on the basis that the current information on their merits was inconclusive.

The recommendations are wide ranging and do attempt to treat the cause of the problem.

### Implementation Plan

The implementation plan was broadly aimed at the following parties:

- the Standards Australia Industry Practice Committee in respect of Industry Codes;
- Standards Australia, NPWC and JCC Contracts Committees in respect of contract matters;
- All signatories to the Construction Industry In-Principle Reform and Development Agreement, which includes State and Federal Governments as well as industry associations in respect of their commitment to all recommendations;
- the CIDA Pre-qualification Review Team in respect of alterations to their pre-qualification criteria;
- Commonwealth and State Ministers in respect of the licensing and registration process;
- the Australian Securities Commission in respect of corporate governance issues.

### Results of the Implementation Plan

The Standards Australia Construction Industry Practice Committee recently reviewed The Australian Code of Tendering - AS4120 and Code of Ethics and Procedures for the Selection of Consultants - AS4121. These codes now contain in full all of the recommendations. They are recommendations 6, 10, 11, 12, 13 and 20 in respect of project funding, bid shopping, notification of tender prices, application of prequalification criteria and commitment to proceed with the project.

The Contracts Committees of Standards Australia,

JCC and NPWC have been notified of our recommendations in respect of contractual provisions and suggested draft clauses have been provided to them. Standards Australia will shortly begin their review of AS2124 Head Contract and AS2545 Subcontract and have agreed to consider the changes proposed. All NPWC members are either using AS2124 or are converting to it and appropriate special conditions of contract in respect of security of payment are available for inclusion. JCC advises they are presently considering the recommendations.

Looking at the level of commitment of In-Principle Agreement signatories. All signatories to the Agreement were asked to commit to the implementation of the recommendations and progress reports have been received as follows:

- The Queensland Minister for Administrative Services has provided a detailed report and advises they are fully committed to implement all of the recommendations. Many have already been implemented, such as prequalification criteria, proof of payment, trust funds for security and retention monies and AS2124 Head Contract with the mandatory use of an unchanged AS2545 Subcontract. The Department is assisting implementation in other Government Departments to ensure a whole of Government approach. The CIDA recommendation to include security of payment measures in State Purchasing Policies has already been put in place thereby casting a much wider net than just capital works projects. The Departments of Transport, Railways and Housing are currently moving to adopt the measures.
- The Western Australian Minister for Works reports many of the recommendations have already been implemented by the Building Management Authority and other construction agencies including the AS2124 and AS2545 contracts and the codes of tendering and ethics and procedures for the selection of consultants.
- The ACT Deputy Chief Minister reports many of the recommendations have already been implemented and is committed fully to implementing all of the recommendations.
- The South Australian Minister for Industrial Affairs is presently undertaking a process to implement the recommendations. They are consulting with the Infrastructure Agencies Forum and the Department for Building Management will provide a co-ordinated and consistent approach across all of Government. They have referred the recommendations to the Construction Industry Advisory Council for advice on how to introduce the measures into the private sector. They advise their initiatives will be based on the CIDA, Qld and NSW measures.
- The Victorian Minister for Housing has expressed concern in respect of some of the recommendations but supports the general thrust. A number of the recommendations have already been introduced including AS2124 and AS2545 contracts and it is

noted the recommendations of their Parliamentary Committee enquiry contains many of the CIDA recommendations.

- The Tasmanian Department of Works has or will incorporate many of the proposals into its documentation.
- BOMA have agreed to inform its members of the importance of security of payment and will recommend the use of head contracts and contract administration to discipline down the line payments.
- NSW although not a signatory to the In-Principle agreement has already adopted many measures consistent with the recommendations.

The Action Team saw the CIDA Prequalification Criteria as an essential plank in its security of payment solutions. Statistics in Table 1 emphasise just how important the PQC and particularly the practical application of financial criteria are to security of payment.

Unfortunately the CIDA PQC review team has seemingly dismissed the recommendations in their recent review. It appears they have not grasped the significance to security of payment of the action team's requests but perhaps that is the fault of the action team for not presenting a more convincing case to them. However, CIDA has been working with the Australian Accounting Research Foundation to develop an auditing guidance release to assist in the audit of a contractor, subcontractor or consultant. This will enable a party to reach a more informed opinion on the financial capacity of those they are dealing with.

CIDA met with members of the National Council of Licensing and Home Warranty Authorities in Adelaide to put a case for the recommendations for uniform licensing and the establishment of a set of common criteria to assess character, financial and technical capacity of applicants seeking registration. The council are now considering the proposals.

A number of meetings have been held with the Australian Securities Commission by a subcommittee of the action team. The ASC has enthusiastically taken up the challenge of our recommendations and have already conducted successful half day educational seminars in Sydney, Melbourne and Brisbane. They are developing an information package on Ascot Information Services to inform CIDA and industry representatives on the type of probity information available and the mechanism for accessing it. They are, in their words, committed to weeding out the bad apples in our industry.

### Work of other committees

What follows is a brief outline of the work being carried out on Security of Payment by other authorities and associations which indicate the current degree of implementation of security of payment measures around the country.

The Security of Payment Industry Committee in NSW undertook a major study. It's recommendations were centered around deemed trusts for all payments. Anderson Consulting were then commissioned to review the work of

that committee but it did not support the deemed trusts proposals. The NSW Construction Policy Steering Committee addressed the problem by the introduction of procedures that tended to reduce risk and potential of loss of payment by;

- bank guarantees in lieu of cash securities and cash retentions;
- placing cash securities and retentions but not payments in trust accounts;
- reflective payment clauses that:
  - ensure equitable payments;
  - prevent paid-if-paid clauses;
  - implement alternative dispute resolution processes; and
  - ensure that the interest rate on payments in subcontracts is the same as in the head contract.

Breaches of the provisions are subject to sanctions under the NSW Code of Practice. The private sector is encouraged to adopt these practices but it is not mandatory.

The Qld Government has introduced the most far reaching and stringent measures of all authorities. They broadly include:

- stringent pre-qualification criteria particularly financial criteria;
- proof of payment in the form of written acknowledgment of receipt of payment;
- an additional 5% security to satisfy subcontractors charges or the establishment of trusts for security and retentions;
- the use of Australian Standard AS2124 Conditions of Head Contract and the mandatory use of back-to-back AS2545 Conditions of Subcontract.

Failure to comply is a breach of contract which results in show cause and possible take over of the contract.

Qld has embodied its measures in its State Purchasing Policy thereby casting a much wider net than just Government capital works.

Qld also has its *Subcontractor's Charges Act* to compliment its contractual and tendering measures and is at the moment drafting improvements to the *Act*.

The South Australian Construction Industry Advisory Council reported and concluded that any solutions should be mandatory across Industry and should address relationships from the outset of the contract process. This approach of addressing the cause rather than the symptoms is of course consistent with the CIDA approach.

The South Australian Department for Building Management and the Advisory Council are currently working on measures which will be based on the CIDA, NSW and Queensland initiatives. It is proposed to include them into a Code of Practice for Government work and possibly make mandatory for the private sector as best practice. They are considering their licensing system as a mechanism for this.

The Victorian Economic Development Committee undertook a major enquiry and recently reported their recommendations to Parliament, which included similar provisions to the Qld provisions, including standard form

contracts - AS2124 Head Contract and AS2545 mandatory subcontract with proof of payment clauses, banning of paid-if-paid clauses, enforceable codes of tendering and practice, pre-qualification criteria and financial and business management training.

The Northern Territory has established a Public Works Pre-qualification and Accreditation program administered by a private company, which includes dissemination of payment systems and records as part of the accreditation process.

Other measures include:

- Payment terms that require payment in 14 days; and
- A Code of Practice that incorporates payment provisions.

It is worthy of note that all of the above initiatives mentioned are consistent with the CIDA recommendations and importantly attempt to get to the cause of the problem.

Master Builders Australia has announced an insurance scheme for the protection of security and retention monies. While some would argue this measure deals only with the symptoms, nevertheless, the Association should be applauded as it is a significant step for that Association in recognition of the security of payment problem in our industry.

National Public Works Council undertook an investigation into the cost effectiveness of Surety Bonds. The results were relatively inconclusive with there being no clear cost advantage.

Obviously, all work being undertaken by various organisations on Security of Payment has not been covered, but it does highlight that the Industry is finally once and for all tackling the real issues. CIDA has certainly achieved at least one of its fundamental aims and that is to raise Industry awareness of a problem, a problem that has been with us for a long time. Finally people have stopped putting up the argument that security of payment in the Building and Construction Industry is no worse than other industries. In any event does it matter? We are about achieving reforms to our own industry and while such undesirable practices continue this industry can never hope to achieve international standing.

**Major initiatives of Ministers of Construction**

If the Industry thinks that security of payment may no longer be an issue when CIDA finally packs up its tent, then it will be quite wrong. Many proponents of Security of Payment would describe what is outlined here as the big breakthrough. The Federal, State and Territory Ministers of Construction met in Brisbane in April and considered the security of payment issue.

In essence they decided that NPWC should address contract relationships by using the CIDA security of payment recommendations together with the NSW and Qld initiatives as models to move towards a consistent set of procedures for implementation nationally.

They decided that there should be a Code of Practice for Security of Payment for building and construction to ensure implementation as minimum requirements.

They further decided that Commonwealth and State Governments should consider mechanisms for promotion of the adoption of these initiatives by the Private Sector through either:

- promotion as good business practice through industry skills development programs; or
- establishment of a mandatory Code of Practice for Security of Payment for both the private and public sectors.

Clearly the message here from the Governments of Australia is that they agree that security of payment is a right and have instructed it be elevated at least to code of practice status and possibly legislative status.

NPWC is currently moving to address these decisions as a matter of priority and answers are expected by August. As with any Industry Code there should be consultation with Industry there is no reason why this will not occur in this instance. There would, however, be no contemplation of any further research or work on new initiatives. It is a matter of choosing a range of measures which offer a reasonable measure of protection.

Obviously breaches or abuse of any Code of Practice will invoke sanctions from Government which would as a minimum be in respect of further Government work but could if the code is made mandatory for the private sector, be as far reaching as effecting builders licences.

**Do the CIDA Recommendations really work?**

**Table 1 - Contract Failures**

88/89	7 Contractors	14 Contracts
89/90	9 Contractors	14 Contracts
90/91	5 Contractors	22 Contracts
91/92	14 Contractors	27 Contracts
92/93	5 Contractors	21 Contracts
93/94	0 Contractors	0 Contracts
94/95	0 Contractors	0 Contracts

**Prequalification Commenced in August 1992**

The figures in table 1 represents statistics gathered by my Department over the past seven years in respect of contract failures. It lists the number of contractors and contracts where default occurred in any one year. The peak period of disaster for us was 1991/92 where a total of 14 contractors failed on capital works projects in our State. There is a dramatic decline of failures for 1992/93, 93/94, 94/95 and not co-incidentally prequalification with stringent financial criteria was introduced in mid 1992. The CIDA Action Team pointed out in its report the direct link between financial pre-qualification criteria and default and, of course, the consequential virtual elimination of non-payment problems for those lower in the chain. The Action Team and the CIDA Board cannot stress too highly the importance of knowing who you deal with and the proper professional assessment of that risk.

**Table 2 - Number of Charges lodged Subcontractors Charges Act**

89/90	49
90/91	121
91/92	269
92/93	73
93/94	33
94/95	12

**Total value of all charges was \$12.2m  
Security of Payment was introduced in June 1993**

Queensland has the *Subcontractor's Charges Act* which is a form of liens legislation whereby the Principal is obliged to withhold from progress payments the value of a charge lodged by a subcontractor. A charge is lodged by a subcontractor where it considers it has not been paid. The figures in Table 11 indicate the number of charges lodged in any one year with my Department. The number of charges lodged are of course a direct reflection of payment difficulties being experienced in the Industry at that time. Again 1991/92 was a peak year where 269 charges were lodged. As indicated, the numbers have steadily dropped and to date only 12 charges have been lodged this year. The figures are directly attributed to the introduction in June 1993 of my Department's contractual security of payment measures which include a proof of payment system where an actual signed declaration of receipt of payment by the subcontractor is required.

It cannot be denied that there is a small cost to industry and the Government in the administration of these measures but the return in monetary terms for the Government alone is evident when one looks at the huge costs when a default occurs or when a subcontractor's charge has to be dealt with both administratively and in the courts. It is not too difficult to imagine the costs of administering 269 charges in a year and the courts having to deal with them, not to mention the losses to those who did not get paid. Since the introduction of our measures there have to my knowledge been no subcontractors who have not been paid monies due and owing to them on any project containing these measures and which was let by my Department. This would of course exclude disputed monies and the few charges which have been lodged they are generally on account of disputes.

Importantly these measures have been accepted by Industry in Queensland and are working smoothly. It should be noted they are in many respects exactly the same contractual and tendering measures that CIDA is recommending.

The Queensland Government has had the courage to confront the problem head on. We have found solutions that offer a reasonable level of protection. Clearly it has paid off.

**Security of Payment - the future**

So when the dust finally settles what might we be left with at the end of the day as the accepted norm for Security

of Payment?

- Prequalification of tenderers in respect of financial criteria will become the accepted practice. You won't get on a tender list if your financial position is not compatible with the size of project being tendered. If the assets and profit are being syphoned off into another company, then you can expect to be asked to provide a Deed of Guarantee from that company.
- There will be standard form head contracts with few amendments and there will be back to back mandatory subcontracts. History shows that lawyer drafted contracts which attempt to place all the risk on one party do not live up to their promise of delivery of a project within budget.
- The surety of interpretation and understanding offered in a standard form contract with equitable allocation of risk in my opinion offers a greater protection for Principals and has the added spin off of similarly assisting those lower in the chain through back to back standard form subcontracts. The assistance to the security of payment problem through this measure alone is immeasurable.
- There will be proof of payment in all of our contracts in the form of an actual signed record of payment of monies due and owing. This will replace the farcical so called proof of payment in present contracts whereby statutory declarations are provided which have proved to be not worth the paper they are written on.
- Security and retention monies will not be allowed to become a part of another party's cash flow. They will be held in trust. And why shouldn't they be so held? A party holding such monies has no right to them unless a default occurs. Sectors of the Industry complain that this measure is detrimentally altering the basic structure of contracting by drastically affecting working capital. In reply, such companies are trading at the margins and are not a good business risk. Clients are unlikely in future to continue to deal with such companies.
- Pay-if-paid clauses (i.e. I never have to pay you if I myself do not get paid) will no longer be seen in any contract.
- Governments will enforce security of payment measures through a Code of Practice with appropriate sanctions for breaches or abuses. Whether that code is made mandatory for the private sector will be a matter for each individual agency but either way Governments clearly are going to force the issue. □