



**National Action on
Security of Payment
in the Construction Industry**

Adelaide 1996

In late 1996 the National Public Works Council (NPWC) was amalgamated with the Chief Executive Officers Forum on Common Service Delivery to form the Australian Procurement and Construction Council Inc. (APCC).

The APCC is the national reference for policy advice on procurement and construction matters and is the peak Council for industry interface for the Commonwealth, State and Territory Governments in these matters. The APCC convenes meetings of the Australian Procurement and Construction Ministerial Council.

The APCC will continue the work of the NPWC regarding security of payment in the construction industry.

Meeting of Construction Ministers
National Public Works Council
National Action on Security of Payment in the Construction Industry in Australia
Adelaide, 1996

Requests for additional copies of this document should be addressed to:

Australian Procurement & Construction Council Inc. (APCC)
PO Box 106 Deakin West ACT 2600
6-42 Geils Court Deakin ACT 2600

Phone 02 6285 2255 fax 02 6282 2727 / 02 6282 3787
E-mail: info@apcc.gov.au
Web Site: <http://www.apcc.gov.au>

Reprinted October 1997, June 1999

CONTENTS

THE PROBLEM	1
AGREED NATIONAL PRINCIPLES	2
AGREED NATIONAL ACTIONS	3
ASSESSMENT OF PARTICIPANTS	3
CODES OF PRACTICE AND CODES OF TENDERING	3
PROMPT PAYMENT	4
BACK-TO-BACK PAYMENT CONDITIONS	4
PROOF OF PAYMENT	4
ALTERNATIVE DISPUTE RESOLUTION	4
EXCLUSION OF PAYMENT RESTRICTIONS	5
HEAD CONTRACTOR PERFORMANCE GUARANTEES	5
CO-OPERATIVE CONTRACTING	5
AGREED ACTIONS FOR FURTHER CONSIDERATION	6
INSURANCE	6
MUTUAL FUND INSURANCE	6
MEASURES NOT ADOPTED FOR ACTION	7
APCC MEMBER AUTHORITIES	8

THE PROBLEM

The building and construction industry in Australia has been unable to consistently ensure that participants are paid in full and on time for the proper performance of work, despite contractual obligations to do so. This problem is one of the most complex and controversial issues in the industry today. It is usually labelled "security of payment".

Security of payment problems, while not unique to the construction industry, are often seen to be worse in this industry than in others. The structure of the construction industry is a multi-tiered hierarchy of principals, agents, contractors, sub-contractors and suppliers, with cascading payment obligations. The industry in Australia has quite low capital backing and a heavy reliance on cash-flows to sustain business. It is easy to enter the industry, and participants sometimes lack the skills and expertise necessary to survive. The industry has received considerable criticism in the past for not maintaining consistently high standards of ethical conduct.

The inability to assure payments may occur at any level in the hierarchy. There is a popular perception however, that the worst problems occur with payments from head contractors to specialist sub-contractors and other suppliers further down the contractual chain. As sub-contractors and suppliers provide 80-90% of trade work associated with projects, their risk level of non-payment is high. Security of payment problems include not being paid on time, receiving only part payment for work completed, or not being paid at all. The problems are worse when a participant higher in the contractual chain becomes insolvent, and when the sub-contractor is indebted to other sub-contractors and suppliers.

Because the industry is diverse and segmented, it does not have a unanimous view on how best to tackle the payment problem. The issue remains a difficult and sensitive one. There is a difference of opinion ranging from an expectation that the markets should deal with the problem, to the view that governments should act to remedy security of payment through legislation of requirements for payment.

Whatever the solution, it is obvious that the cost of implementation must not exceed the cost of the problem being addressed. Costing the problem is however, difficult. Costs to individual parties (mainly sub-contractors) are sometimes available. The impact of these costs on the industry as a whole is not so clearly established. Figures presented by Anderson Consulting in 1993 and sourced from the *Royal Commission Into Productivity In The Building Industry in NSW* suggest that monies lost from late payment were 0.34% of turnover and losses from payment default were 2.50% of turnover.

These figures are not high in industry terms but this is small comfort to the individual sub-contractors who suffer the losses. In addition it is of concern that the recent Australian Securities Commission report on phoenix companies indicates that almost 50% of such companies operate in the building and construction industry.

AGREED NATIONAL PRINCIPLES

Commonwealth, State and Territory Ministers responsible for construction endorsed, on 15 January 1996, the following set of principles applying to security of payment. These principles form the foundation for the program of national action presented here and being taken across all government jurisdictions.

1. Participants have the right to receive full payment as and when due;
2. All cash security and retention monies should be secured for the benefit of the party entitled to receive them;
3. Payment periods lower in the contractual chain should be compatible with those in the head contract;
4. Outstanding payments to participants, to the extent consistent with Commonwealth and State legislation, should receive priority over payments to other unsecured creditors;
5. All construction contracts should provide for non payment to be a substantial breach;
6. All construction contracts should make provision for alternative dispute resolution mechanisms;
7. Only those parties who have the financial and technical capacity and business management skills to carry out and complete their obligations should participate in the industry; and
8. All construction contracts in the contractual chain should be in writing.

These principles of conduct have been adopted by all governments in their dealings with the construction industry. They will be applied through the agreed National Action and the initiatives of individual jurisdictions, many of which are already in place.

Government agencies shall also develop appropriate sanctions consistent with their business activities and the laws applicable in their respective jurisdictions to achieve compliance with the principles.

Achievement of best practice throughout the industry is the responsibility of all participants and adoption of the principles in private sector projects is strongly encouraged. The industry as a whole and the community will be best served if industry participants adhere to high standards of honesty, integrity and good faith.

AGREED NATIONAL ACTIONS

Governments are major buyers of construction and related services. As principals in construction projects, government clients play a lead role in establishing security of payment best practice, while at the same time respecting the contractual relationships between other participants.

Through the adoption of best practice, Governments will create new industry standards and effect the way in which other participants in the industry do business.

Governments around Australia are focussing on actions that address underlying causes of security of payment, not simply the symptoms. Consequently, they are implementing strategies that address the quality of industry participants.

Assessment of Participants

The importance of pre-qualifying those entering and working in the industry as a measure to address security of payment is well accepted. Assessment of the financial, technical and management capacity of contractors and consultants prior to their involvement in tendering for work ensures that only those with sufficient capacity participate in the industry. Government principals will increasingly adopt and apply pre-qualification in conjunction with industry. Addressing the entry levels of participants will assist in the development of a national industry and act as a catalyst to change industry's culture.

To support this process APCC will develop and promote national pre-qualification criteria to rationalise and promote industry application.

Codes of Practice and Codes of Tendering

Government principals have or shall adopt Codes of Practice and Codes of Tendering appropriate to their jurisdictions.

These Codes reflect or exceed the minimum standards of behaviour expected of project participants and expressed in the national principles as embodied in the National Code of Practice. They draw upon the well established practices of probity and fair dealing that have long been a part of public sector building and construction procurement.

It should be noted that several industry associations have also published Codes that reflect the content of those prepared by Governments and which promote the principles more generally within the private sector.

AGREED NATIONAL ACTIONS

Prompt Payment

Government principals shall require that moneys due to project participants down the contractual chain are paid within a specified time, once payment is due to the head contractor. Requirements contained within industry agreed general conditions of contract such as AS2124 and AS4300 for reflective or back-to-back contracts provide payment conditions for sub-contractors that are the same as those for the head contractor.

Back-to-Back Payment Conditions

Government principals shall require the use of “back-to-back” forms of sub-contract conditions to ensure that payment provisions and periods in sub-contracts are compatible with those in the head contract.

Proof of Payment

Government principals shall require head contract provisions for proof of payment down the contractual chain.

Alternative proof of payment procedures are being explored by some APCC members to evaluate their application and cost effectiveness. It is also recognised that effectiveness of proof of payment mechanisms is significantly increased when used in conjunction with Alternative Dispute Resolution methods.

Alternative Dispute Resolution

Government principals shall require the option of using alternative dispute resolution processes as a prerequisite to arbitration and/or litigation in all head contracts and sub-contracts down the contractual chain.

It is preferable that the industry pursues co-operative contracting and the resolution of disputes through direct negotiation. The provision of alternative dispute resolution mechanisms in building contracts should assist in accelerating payments and reducing the costs of the resolution of disputes.

Alternative dispute resolution refers to direct negotiation or consensus dispute resolution such as conciliation and mediation. Industry bodies will be asked to consider development of a comprehensive education program, covering all levels of the delivery process, and focus in particular on sub-contractors and suppliers with limited experience in alternative dispute resolution including consensual dispute resolution.

AGREED NATIONAL ACTIONS

APCC will investigate the need for, and feasibility of, a register of specialist mediators and conciliators to be available Federally and in each State to handle building disputes at short notice. This would assist in consensual dispute resolution.

Exclusion of Payment Restrictions

Government principals shall exclude and disallow “pay when paid” and “pay if paid” payment provision in all contracts and sub-contracts down the contractual chain.

Head Contractor Performance Guarantees

The standard acceptable form of security provided to government principals to ensure due and proper performance of the head contract shall be an unconditional bank undertaking, ie a bank guarantee.

Co-operative Contracting

To reduce time, cost or project over-runs, it is recognised that every effort should be made to share project expectations, co-operate on problem definition and resolution, and take all steps possible to prevent conflicts from escalating into claims or disputes. Such measures are already promoted and used by most Government agencies.

It is in the interests of all participants to facilitate an appropriate business environment through the implementation of co-operative contracting which can include partnering, teaming and the development of non-adversarial relationships at all levels. Government principals need to continue their commitment to developing these processes and to encouraging co-operation and trust down the contractual chain.

The feasibility of improving security of payment through a new, standard co-operative form of contract should be examined by all industry participants, possibly through Standards Australia.

AGREED ACTIONS FOR FURTHER CONSIDERATION

Insurance

The viability of insurance as an option to provide protection is dependent on several factors, including whether the premium levels can be realised. Therefore the insurance industry needs to measure the size of the default problem and hence to quantify the potential risk.

Although the impact of insurance occurs after the event, its introduction may assist in a change in the behavioural patterns in the building and construction industry. Similar favourable effects were achieved through workers' compensation in terms of bonus or penalties in premiums for good or bad performances in claims experience.

A relevant insurance scheme is likely to be difficult to achieve but it is acknowledged that industry participants may wish to pursue this option as an additional measure to address security of payment. Consideration of the inclusion of insurance as a contractual requirement should be given only if a viable insurance proposal is established.

Mutual Fund Insurance

In a report commissioned by the National Public Works Council entitled *Improving Security of Payment in the Building and Construction Industry*, Price Waterhouse discussed the option of Mutual Fund Insurance. Mutual funds are similar in concept to insurance in that they provide security to the subcontractors in the event of insolvency of the head contractor.

With insurance, the premium monies are paid to the insurance company, either directly or through an insurance broker and then retained by the insurer. The premiums are not generally reduced in subsequent years, but may increase if the risk of the individual insured party increases, or if there are adverse claims experiences.

With mutual funds, monies are paid, retained and invested, and continue to exist as 'fund monies'. From time to time there may be a reduction in the required contributions from participants as the balance remaining in the fund is sufficient to cover predicted risk levels.

A mutual fund could provide aggrieved sub-contractors with the means to apply for reimbursement of losses incurred as a result of the default of a head contractor due to insolvency. It does not necessarily address other circumstances of non-payment.

Industry participants may wish to pursue the establishment of a construction industry mutual fund on a coordinated national basis through relevant industry associations, employer and employee organisations and unions. The role of Governments in the establishment of these funds needs to be considered in consultation with industry.

MEASURES NOT ADOPTED FOR ACTION

At a national level there is agreement not to adopt particular actions that have been widely debated. These actions include:

- operation of trusts in the payment chain;
- surety bonding;
- direct payment of sub-contractors by third party principals;
- priority payments;
- prompt payment legislation; and
- liens.

The cost of these measures relative to the industry problems are considered to be prohibitive. In particular, the complex commercial and administrative burdens and obligations suggest that the potential cost of any widespread trust arrangements is of concern. The workability of trusts would also be compromised by the detailed legal issues and considerations involved with trust law.

In addition, difficulties associated with related enforcement mechanisms and the requirements for legislative backing are not acceptable by Governments or many in industry. Importantly, the potential risk for principals that they may be forced to pay twice for materials or services is particularly unacceptable.

APCC MEMBER AUTHORITIES (At June 1999)

Department of Finance and Administration

Commonwealth

Department of Public Works and Services

New South Wales

Department of Infrastructure

Victoria

Procurement Branch, Department of Treasury & Finance

Victoria

Department of Public Works

Queensland

Department for Administrative and Information Services

South Australia

Department of Contract and Management Services

Western Australia

State Supply Commission

Western Australia

Department of Transport and Works

Northern Territory

Department of Industries and Business

Northern Territory

Department of Urban Services

Australian Capital Territory

Ministry of Commerce

New Zealand
