20 Years of the Construction Contracts Act 2002

To boldly go …

AMINZ Construction Day
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> The Act therefore has a focus on a payment procedure, the results that arise from the observance or non-observance of those procedures, and the quick resolution of disputes. The processes that it sets up are designed to side-step immediate engagement on the substantive issues such as set-off for poor workmanship which were in the past so often used as tools for unscrupulous principals and head contractors to delay payments. As far as the principal is concerned, the regime set up is "sudden death". Should the principal not follow the correct procedure, it can be obliged to pay in the interim what is claimed, whatever the merits. In that way if a principal does not act in accordance with the quick procedures of the Act, that principal, rather than the contractor and sub-contractors, will have to bear the consequences of delay in terms of cashflow.
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> *Marsden Villas Limited v Wooding Construction Limited*
> [2007] 1 NZLR 807 per Asher J, at [17]

1. Introduction

It is now almost 50 years since Lord Denning MR's recognition of cashflow as "the very lifeblood" of the building trade was struck down as heresy by the House of Lords in *Gilbert-Ash v Modern Engineering*. It was arguably that observation which started the security of payment legislation which have been enacted around the world.

I do not propose to engage in a romp through the amendments to our Act, or to analyse how the courts have risen to the challenge of such a new regime. Instead, in this paper, I will consider how effective the Act has been in achieving its purposes, and to propose a number of questions which might warrant further consideration.

2. Background to the passing of the Act

When I was in my first year of secondary school, Auckland based construction company JBL collapsed, causing shockwaves and headline news throughout the country. It had offices in Australia and Japan and was considering opening new headquarters in London. It was engaged in construction, property development, fishing, mining and exploration. Over 3,000 investors lost their money, many others lost their jobs and over 2,000 creditors lost money. One of the founding brothers, Jim Jeffs, went to prison. At the time, the received wisdom was that the company "went too far too fast". The more prosaic reasons were a

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lack of working capital and poor management; reasons, I would suggest, which also define most corporate failures since.

Fast forward to 2001, and another family company, Hartner Construction went under leaving debts totalling more than $30 million and no funds available for unsecured creditors (read subcontractors). That was followed 12 years later by Mainzeal Property & Construction which left $130 million owing to unsecured creditors (again, read subcontractors).

While we followed the UK and NSW in enacting security of payment and adjudication legislation in 2002, the question must be asked, with ongoing failures of construction firms, is the Act working?

Various industry groups and politicians have rushed to promote their preferred solutions. None, in my view, appear to have considered the root causes of the industry's ongoing issues.

Construction procurement, both in the building industry and in infrastructure development, is unusual in that the owner is contracting, within an uncertain time frame, for the development of an asset which is not fully designed, is not fully priced and which most cannot actually afford (without funding). Construction contracts provide a framework for allocating risk, for dealing with those uncertainties and for dealing with disagreement.

Against that, contractors are typically asked to provide firm, if not fixed prices, in a competitive environment where they cannot, in the current economic climate, reliably secure supply and subcontractor prices. We seem to assume that there is a pool of properly skilled, resourced and fully capitalised contractors available to complete work in a stable environment; an environment where we expect them to take on liability many multiples of their working capital, and in which their profit expectations are relatively modest. This is a race to the bottom, where price, quality and timely delivery inevitably suffer.

The root cause of the failure of the construction industry has to be the approach we take to procurement, and the failure to acknowledge or understand how the industry actually works, rather than some idealised fantasy.

In the UK, the Government procured a review of its construction industry back in 1994, which had been described as dysfunctional. In his *Constructing the Team* report, Sir Michael Latham made a number of recommendations, which included increased cooperation, a new approach to contracting and streamlined and proactive dispute resolution. Among the outcomes of his review was the New Engineering Contract (the NEC3 suite of contracts), published by the Institution of Civil Engineers in 2005 and the Housing Grants, Construction and Regeneration Act 1996, which provided for adjudication of construction disputes in section 108.

NSW followed with its security of payment legislation in the same year.

At that time, the protections available for contractors in NZ were few, and many of the criticisms levelled at the UK industry applied here as well.

There is no common law right to progress payments, and the position remains that any instalments of the contract price are paid on account until final completion is certified.

The line of cases following *Dawnay's* and *Gilbert-Ash* established that there is no security of payment of interim invoices. Owners were free to make deductions from payment claims, leaving contractors hopelessly exposed to their suppliers and subcontractors.

When left unpaid, the *Canterbury Pipe Lines* case confirmed that in NZ there is no common law right to suspend work for non-payment. Not only were contractors starved of cashflow, they were required to keep working, while exposed to their suppliers and subcontractors. Subcontractors were similarly exposed to cash flow coming down the contract chain.

Some comfort was offered by section 21 of the Wage Earners' Protection and Contractors' Liens Act 1939, which provided that any contractor, subcontractor or worker (of any tier) employed to carry out work on land was entitled to a lien over the land for all amounts unpaid. In practical terms, this meant that any purchaser of land, or their solicitors, had to ensure that the vendor had paid for all work carried out on the property. That legislation was repealed in 1987.

Into that void came the Construction Contracts Act in 2002, and its aspirational purposes – to facilitate regular and timely payments, to provide for the speedy resolution of disputes; and remedies for recovery of payments. Bold aspirations. Has it performed?

When the Construction Contracts Bill was introduced in 2001, its "General Policy Statement" noted that payments under construction contracts are typically in arrears. At that point the owner has the unencumbered benefit of the work:

> *… This pattern of payments often means that the developer, principal, or head contractor with cash flow problems may deliberately delay payment for work done and, in effect, use those further down the contractual chain (for example, subcontractors) to partly finance the construction project …*
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> *… subcontractors are not always aware whether firms further up the contractual chain have actually been paid or not. This provides an opportunity for head contractors to withhold or divert payments from the subcontractors for completed work … If a head contractor's business fails after the subcontractors have been carrying out work for some time without being paid, the consequences for subcontractors involved are significant, including business failure and job losses for the subcontractor's employees.*

This was exactly the case with the failures of both Hartner Construction and Mainzeal; the latter occurring some 10 years after the passing of the Act. In each case, subcontractors carried out work to the direct benefit of the owner/developers, with no recourse under the Act once the head contractors went into liquidation, as there was no direct contractual nexus between the owners and the subcontractors. It is unfortunate that the very issue identified in the General Policy Statement has never been properly addressed in the Act or its subsequent amendments.

Into that mix, it should not be forgotten that subcontractors and suppliers have no retention of title, except in the rare occasions where they have effectively registered their interest on the Personal Property Securities Register.

The failure to protect all tiers of the construction supply chain identified by Denning over 50 years ago in *Dawnays* remains.

The balance of the recommendations by Sir Michael Latham in the UK and in Australia in its 2005 survey of *Pressure Points in the Construction Industry* have not been addressed in NZ. Some optimism may be found in the *Construction Sector Accord* and the review of NZS3910 by both Standards NZ and the Infrastructure Commission – Te Waihanga, but it is likely the current crisis, and company failures, will endure.

Off-topic, it does need to be acknowledged that the Government and the wider government sector is the biggest procurer in the construction industry, by number and value, by a considerable margin. Any reform must start at the top, and must be driven by a significant change in attitudes – first, by carrying out detailed investigations and developing designs before seeking prices from contractors to reduce uncertainty and properly manage risk; second, by moving away from risk transfer inherent in competitive tendering procedures; and last by acknowledging that a project will cost what it will cost, and allowing the contractor to make a profit.

But I digress.

3. Amendments, and what's missing

Since the Act came into force on 1 April 2003, it is fair to say that payment behaviours at head contractor level have largely improved. Paid when paid / if paid clauses have, with few exceptions, been consigned into history, and most in the construction industry understand and comply, if only in a formal sense, with the payment claim / payment schedule procedures.

In the early days, the Court of Appeal in *Canam v George* enjoined the industry not to engage in technical quibbles in relation to what appeared to be mandatory requirements for payment claims in section 20. And in *Fletcher Construction v Spotless* the High Court bravely embarked on a consideration of exactly how tightly the line of non-compliance with section 21 is to be applied to payment schedules.

There are times when we all need to be reminded of Harrison J's comments in *Metalcraft* that the purpose of a payment schedule is to give the contractor full and unequivocal notice of the areas of difference or dispute to enable it to properly assess its future options.

Adjudication has, perhaps, been a more mixed bag.

When the NZ legislation was introduced, Humphrey Lloyd QC famously described our version of adjudication as "ferocious". Unlike the NSW security of payments legislation which applies only to payment obligations, and the UK legislation, which provided for greater agreement between the parties in relation to adjudicating disputes, our Act provided a wider jurisdiction and strict time frames for adjudicating disputes under construction contracts.

2015 Amendments

After an at times shaky start, the 2015 amendments extended the definition of construction contract to include design, engineering and quantity surveyoring; removed the unhelpful

distinctions between residential and commercial construction contracts; also removed the confusing binding but not enforceable status of determinations on rights and obligations; clarified the adjudication procedure by easing the time for a response, adding rights of reply and rejoinder; and established a statutory trust for retention moneys.

Further amendment is proposed (currently in the Committee of the Whole) to strengthen the protection of retentions. It is hard to see the retention amendments achieving much in the context of the amounts owed to unsecured creditors. Had the retention provisions been in place prior to Mainzeal's collapse, it would not have protected subcontractors from the $8 million retention shortfall or the $130 million overall shortfall in payments to unsecured creditors. The impact of either setting aside or making allowance for retentions is significant on the cashflow for projects (the very thing that the Act was intended to protect), and focusing on retentions fails to address the elephant in the room – securing progress payment down the contract chain.

That said, adjudication has, it is fair to say, largely worked well.

But there is room for improvement.

4. Making adjudication work

There can be no doubt that, in its vanilla form, adjudication under the Act is "speedy".

The extent to which disputes are actually "resolved", however, is open to question in two respects – (1) the reluctance of counsel and clients to refer disputes to adjudication; and (2) the durability of the resulting determinations. Much of this arises from the increasing cost of the process, the quality of the determinations and their enforceability (dealt with in the next section).

In an early case to come before the Technology & Construction Court in the UK, *Outwing Construction v Randell*, Justice Humphrey Lloyd QC's comments are apposite to the NZ legislation:

> *It is clear that the purpose of the Act is that disputes are resolved quickly and effectively and then put to one side, and revived, if at all, in litigation or arbitration, the hope being that the decision of the adjudicator might be accepted or form the basis of a compromise, or might usefully inform the parties as to the possible reaction of the ultimate tribunal.*

Consistent with those observations, John Redmond in *Adjudication in Construction Contracts,* also in the UK, commented:

> *The real skill of the adjudicator lies in* [his/her] *ability to identify the issues and assess the evidence.*

If we are to achieve those goals, there are a number of specific areas for improvement:

(1) A notice of dispute does not need to be a "declaration of war"; the parties are well aware of the issues in dispute, and should define those issues narrowly and with clarity.

Disagreement at some level is almost inevitable in most construction contracts. For successful project outcomes, such disagreement must not derail the project as a whole,

and is best identified early and dealt with properly. Adjudication remains the best means of doing so.

(2) Adjudicators are better appointed by agreement.

In any dispute resolution process, party autonomy is at its most powerful, and critical, when selecting the decision maker. While there are timing and procedural benefits in applying to the increasing proliferation of authorised nominating authorities, this is a poor approach to take when the durability of the decision, whether an adjudication determination or arbitral award, is of paramount importance.

The growing number of lawyers with construction law experience, and the relatively small pool of construction arbitrators and adjudicators, lends itself well to informed and sensible appointments by agreement between counsel. Just pick up the phone.

(3) There is significant flexibility for counsel and adjudicators to refine the adjudication procedure to better resolve the issues in dispute.

(4) Submissions, witness statements, bundles of documents and case authorities should be refined to address only the specific issues in dispute, and to do so properly.

(5) Experts should be used on a common basis, with input from the parties and the adjudicator as to the questions asked and the information provided.

(6) Costs need to be proportionate and addressed with input from clients.

(7) Consideration should be given to mentoring adjudicators and peer reviewing determinations. Publication should be considered as part of that.

This is a thorny issue, with construction disputes traditionally being dealt with in private. While few, if any, parties to adjudication have waived their rights to privacy, the converse is also true; few, if any, insist on privacy if given that option. The entire determination falls into the public domain in the event of judicial review or if the substance of the dispute comes before the court.

The biggest failing in adjudication is not recognising that payment disputes across projects are interlinked.

Adjudication is available only in respect of disputes arising under specific construction contracts – whether a head contract, a design appointment agreement or a subcontract, determinations are not carried over from one contract to another in the same project. A determination that an owner must pay a disputed amount to a head contractor brings no benefit to subcontractors; and a determination that a subcontractor is entitled to be paid establishes no liability on the owner to ensure such payment is made. In each case, there is no basis for such third parties to be heard or taken into account in relation to payment disputes which directly affect them.

Historically, there has been a tendency for contractors to argue that payments by owners under head contracts are theirs to disburse as they please, as noted in the General Policy Statement quoted above. Like any Ponzi scheme, when the music stops there are a number of payment claims looking for a home. The Hartner and Mainzeal failures, which respectively drove the passing of the Act and its amendments in 2015, are cases in point.

Payments under construction contracts are project wide – they have flow-on effects, as recognised originally by Lord Denning in *Dawnays* and on the introduction of the Bill. While

the owner may pay significant amounts to head contractors in progress payments, very little of those payments are retained by the head contractor to cover its own costs. The majority is due to subcontractors and suppliers who provide goods, materials and construction work directly to the benefit of the owner.

Various attempts to impose or recognise trusts in respect of payments due further down the contract train have failed, primarily for a lack of stated purpose and the setting aside of funds.

There are a number potential approaches, short of re-introducing the Wage Earners' Protection and Contractors' Liens Act or imposing statutory trusts:

(1) Ensuring as a matter of contract that progress payments to head contractors are properly disbursed to subcontractors by providing for the registration of subcontracts with owners, requiring identification and proof of payment of progress payments and providing for direct payment of subcontractors when the head contractor is in default.

(2) Allowing subcontractors to join in head contract adjudications to obtain orders that subcontractors are to be paid directly from amounts determined due.

(3) Providing for owners to be liable for payment of amounts determined to be due to subcontractors from head contractors in adjudication.

The Act already provides for approval of charging orders over related third party's land; recognising the interrelationship of the owner, head contractor and subcontractors is not the leap it might initially appear to be.

The first proposal is already increasingly required by project funders.

The second and third proposals simply recognise that owners have an interest in ensuring that subcontractors who carry out the majority of the work get paid. In practical terms, the second and third proposals will push owners and their financiers to ensure compliance with the first.

Without some recognition of the interests of subcontractors in project cashflow, the Act is unlikely to achieve its full potential.

5. Enforcement

Questions of enforcement arise primarily in relation to payment, whether arising from a failure to respond to a payment claim (sections 22 & 23); a failure to pay a scheduled amount (section 24); or a failure to pay an amount due under an adjudicator's determination (section 59). In each case, the court may not give effect to any counterclaim, set-off or cross demand in any proceedings for recovery of the debt (section 79).

Increasingly, proceedings for recovery of debt is had through bankruptcy and statutory demand proceedings. In defence of such proceedings, arguments are made that bankruptcy and statutory demand are not proceedings for the recovery of debts; determinations in adjudication are interim only, made on incomplete evidence in a tight timescale; as section 79 precludes counterclaims, set-off and cross-demands, such

determinations are not final; and the payee (often without supporting evidence) may itself be insolvent.

The issue is a real one. Under the pay now argue later regime of the Act, if the payer fails to respond to a payment claim, fails to pay a scheduled amount or to comply with a determination, the payee is to hold the disputed moneys pending determination of the merits of the dispute, without the protection of any implied trust or priority against other creditors. Once the merits have been determined, then the payee may be required to repay all or part of the disputed amount.

In the event that the payee becomes insolvent in the interim, then such moneys are added to the pool of funds available to all creditors according to their priority. It is for that reason that we are increasingly seeing payments into court (as in the *Fletcher v Spotless* litigation) and allegations of insolvency to resist summary judgment for debts established under the Act.

This issue was covered in some detail by the Court of Appeal in 2009 in *Laywood & Rees*, with the court recognising that bankruptcy proceedings and statutory demands were legitimate means of recovering debt; and that the combined effect of sections 73 & 79 were to make an adjudicator's determination "final" in terms of the Insolvency Act. If the contrary view were to be adopted, in the words of Justice Arnold, "*the efficacy of the section 73 process would be undermined. Parties to construction contracts could refuse to pay an amount ordered by an adjudicator, and resist bankruptcy notices or statutory demands in relation to the debt, on the basis that they had a counterclaim, set-off or cross-demand. The effect of this would simply be to recreate similar problems to those which led to the enactment of the CCA, albeit in a different context.*"

And yet, in a number of cases (*Concrete Structures v NMHB* and *Kariiti v Donovan Drainage & Earthmoving* to name but two), the courts have allowed judgment debtors to raise counterclaims and set-off in bankruptcy proceedings as there would be no opportunity to "argue later". Contrary to the Court of Appeal's decision in *Laywood & Rees*, subsequent courts have held that an adjudicator's determination is not final.

It is unclear whether those decisions were simply per incuriam (ie without the benefit of either counsel citing the Court of Appeal in *Laywood & Rees*), or if there is a shift from what must have been a high point in the Court of Appeal's decision. If the Act is to have any real affect, the Court of Appeal's reasoning must be correct.

It is also worth remembering that in two adjudications, judicial review hearings and appeals to the Court of Appeal, Laywood Construction, the contractor in the Marsden Villas litigation, succeeded in all forums over a number of years, and yet failed to be paid any amount to which it was due. Bankruptcy and statutory demands were the only means left available to them to recover what was owed.

One of the core principles of the Act, as established by Justice Asher in *Marsden Villas*, is pay-now-argue-later, whether at a substantial hearing or in bankruptcy/insolvency proceedings.

6. Conclusion

If we return to the question posed at the head of this paper; has the Act achieved its purposes?

At some levels, the Act has secured timely payments. Pay when paid / pay if paid clauses have been swept away and the Act provides greater security for payment; at least at one level.

Where the Act has failed is in securing payment down the length of the contract chain, and ensuring that payment is actually made. Greater effort needs to be made to ensure that payments made by owners and their financiers for the project properly flows down to those doing the work.

Generally, adjudication does provide for the speedy resolution of disputes, however it could do better. Adjudication is very effective where the parties use the procedure proactively to procure a durable opinion on defined issues in dispute.

Enforcement also requires further attention. In too many cases, success in adjudication has not resulted in actual payment. We perhaps need to be reminded of the primacy of the pay now argue later regime central to the Act. More widely, enforcement must focus on the needs of the industry than on the niceties of legal reasoning. It should not be forgotten that "payers" can protect themselves through issuing payment schedules and progressing disputes through arbitration or their own adjudications on the merits. If they fail to do so, the Act requires that they pay.

While the Act provides many potential benefits, in practical terms it falls short in delivering its purposes and needs further reform. That reform needs to focus on the needs of the Act's users; those who pay for our services, and who need timely payment, speedy resolution and effective enforcement the Act promised.

It could do better, and in many ways we could all make better use of the tools the Act provides.

If I may, again, go slightly off-topic, the industry needs more critical reform in procurement practices; the forms of contract we use need to reflect a more cooperative approach; they need to reflect the reality of contracting; and we need to move away from risk transfer to risk allocation which meets the project's specific attributes and the needs of project participants.

This would involve a significant paradigm shift across the profession, including the greater sharing of skills and information through peer reviewing and probity auditing major projects to identify and weed out some of the practises which have got us into the position we are in as an industry.

But I have gone beyond my brief.

As ever, the opinions (and errors) in this presentation are mine, though I would be delighted if they were taken up by others.

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