

How to protect yourself against your construction contractor's insolvency, 21 September 2012

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In brief — Useful contract clauses that may help if your contractor goes under

Broad termination rights, progressive calls on the contractor's security and warranties obtained directly from subcontractors can all help to minimise the disruption if your head contractor becomes insolvent.

Head contractor's insolvency usually causes delays and extra costs

The insolvency of the head contractor or a major subcontractor or supplier on a project creates turmoil. Project principals face the difficult task of completing their project and will almost inevitably suffer substantial delay and additional costs.

Principals will also likely lose protection in relation to defective work because a new contractor will not wish to warrant or fix (without being paid) work done by a previous contractor.

In the last six months a number of companies active in Australia's construction industry have hit trouble. They include Hastie Group, Reed Constructions, Kell & Rigby and St Hilliers Construction.

These recent insolvencies should stand as a stark warning to principals to carefully consider potential insolvency issues when entering into a construction contract. A well drafted construction contract can help navigate the troubled waters following head contractor insolvency. The unamended Australian Standard form contracts are not adequate in this regard.

Set out in brief below are some matters that principals may wish to consider including in their construction contracts to provide some protection in the event of head contractor insolvency. Certain of these points also have equal application for head contractors letting major subcontracts.

Broad termination rights and "take-out" triggers

Consider carefully whether the rights to terminate the contract, or to take work out of the contractor's hands, are sufficiently broad. Do they provide a right to act where the contractor is displaying genuine warning signs of insolvency? Such signs may include suspension of work by the contractor (or a significantly decreased presence on site), evidence of failure of the contractor to pay subcontractors (or increasingly late payments) or a winding up application being filed against the contractor. Other circumstantial evidence will often be present.

A principal may wish to act quickly to procure completion of the project via another contractor. The last thing a principal in that situation wants to discover is that the contract does not entitle it to act.

Progressive calls on the contractor's security

After completing the project via another contractor, a principal will wish to recover its additional costs incurred in doing so (and the relevant Australian Standard contracts, for example, do provide for this). Given that the original contractor is insolvent, the principal's only recourse is likely to be to that contractor's performance security.

However, rather than waiting until the project is complete and the additional costs are known with certainty, the principal may wish to be able to call on the security progressively during completion of the project in

order to cover costs as they are incurred. To permit that, the contract needs to include a provision entitling the principal (or the superintendent) to make interim assessments of what the additional costs will be. The contract must also entitle the principal to progressively call on the security in relation to those interim assessments.

Principals should also carefully consider the amount of security initially requested from a head contractor. Five percent of the contract sum is currently the market standard in relation to building projects in Australia and parties will often agree to that almost by default. However, if there are concerns about the strength of the contractor's balance sheet (and the principal still chooses to contract with it) then more security might be appropriate in order to protect against insolvency risk.

Set-off clause to offset additional costs

The set-off clause in the contract should be drafted so that the principal is entitled to set off, against amounts owing to the contractor, additional costs that the principal anticipates incurring in completing the project via another contractor. This may assist the principal in defending claims by the contractor (or its liquidator) made prior to completion of the project.

Using and/or selling the contractor's equipment

The relevant Australian Standards contracts (AS4000-1997 and AS4902-2000) include a provision entitling the principal to use the contractor's construction plant to complete the project after work is taken out of the contractor's hands. In certain circumstances the principal may ultimately sell that construction plant and use the proceeds in satisfaction of monies owed to the principal by the contractor.

These clauses are often amended by lawyers, but even then they are rarely drafted in such a way as to make it clear whether their intention is to create a "charge" over the contractor's equipment. In the brave new world of the Personal Property Securities Act, for a clause of this nature to have the best prospects of being effective, the clause should be drafted so that it clearly constitutes a "security interest" for the purposes of the PPSA and the principal should then register that security interest on the PPS Register.

Keep in mind, however, that another creditor of the contractor (such as its bank) may have already registered an interest in relation to the contractor's equipment. (For more information about this, please see our earlier article *How will the new Personal Property Securities Regime affect the construction industry in Australia?*)

Obtaining warranties directly from subcontractors, suppliers and consultants

As mentioned earlier, the insolvency of the head contractor will likely leave the principal without a party to have recourse to in relation to defective work. A principal can reduce that risk by obtaining warranties directly from the head contractor's key subcontractors, suppliers and consultants, which entitles the principal to have recourse directly to those parties in place of the insolvent head contractor. Entering into a well drafted "side deed" with those parties will achieve this.

Other controls at the subcontract level

There are various other subcontract controls that a principal might consider, including:

- the ability to compel subcontractors to transfer their subcontracts to the principal or to a replacement head contractor (on reasonable, pre-agreed terms) and the ability to compel the contractor to agree to such transfer
- the ability to compel the contractor to assign the benefit of subcontractors' security to the principal, and
- the right to dictate that certain provisions be included or excluded from key subcontracts (on the basis that the principal may end up with those subcontracts if the head contractor becomes

insolvent). An example in NSW would be a requirement that all subcontracts exclude the operation of Pt 4 of the Civil Liability Act in relation to proportionate liability.

These issues are complex and involve a number of intricacies. A particular problem is how to ensure those controls are actually enforceable. It will be difficult to compel an insolvent contractor to do anything at all, particularly once an administrator or liquidator is formally appointed. The practical commercial reality may be that it is simply not possible to address all of these issues satisfactorily in the contract, but they should at least be considered.

Consider contractor insolvency at the outset

The insolvency of the head contractor will be enormously disruptive for a principal no matter what protections are included in the construction contract. However, there are mechanisms (including those set out above) that can be of great help in minimising that disruption and the loss suffered.

The issues discussed in this article only scratch the surface of the complexities that can arise in an insolvency situation. The wider lesson, perhaps, is for principals to keep in mind (and discuss with their lawyers) the spectre of insolvency in relation to all aspects of preparing and negotiating the construction contract.

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