SUBCONTRACTOR DIRECT PAYMENT

Court of Appeal reconsiders direct payments in *Ebert Construction v Sanson*

This paper was published in the September 2017 edition of LawTalk, *the New Zealand Law Society's monthly magazine and has been submitted to* Construction Law International, *the publication of the International Construction Projects Committee of the International Bar Association.*

> [The voidable insolvent transaction regime in s 292 is] … *to protect an insolvent company's creditors as a whole against a diminution of the assets available to resulting from a transaction which confers an inappropriate advantage on one creditor by allowing that creditor to recover more than it would have in a liquidation. The pari passu principle requires equal treatment of creditors in like positions (in these appeals, unsecured creditors) and facilitates the orderly and efficient realisation of the company's assets for distribution to creditors.*
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> *Allied Concrete Ltd v Metzler* [2015] NZSC 7 at para [1]

1. Direct Payment Agreements

As the value and complexity of construction work has increased over the last few years, there has been a corresponding increase in concern over the diversion of project cashflows away from the work for which payment has been claimed to other projects demanding immediate attention. In a booming market, like all good Ponzi schemes, the use of project cashflows in this way can be managed; in a flat or declining market, as the failure of Mainzeal in 2013 has shown, such behaviour is not sustainable. The first indicator is usually a subcontractor complaining it has not been paid from moneys already certified and released by the owner.

It has become quite common for financiers to require non-contracting parties to enter into direct agreements to regulate how they might exercise their rights under the project contracts and how to deal with default. These agreements can take many forms:

- *Direct subcontractor warranties* – while the standard warranty in NZS3910:2013 provides direct undertakings between the subcontractor and the owner, these documents are frequently amended to include an undertaking that the subcontractor will agree to the novation of its subcontract to the owner, in the event of main contractor default.

- *Interface agreements* – where the project is undertaken under a "construction management" approach, it is common for those direct contracts to be supplemented by an interface agreement, governing how the designer, suppliers and various specialist contractors will work together to complete the project.

- *Tripartite/umbrella agreements* – common in highly leveraged developments where financiers want comfort that if any project participant fails – for example in a commercial development, the developer, main contractor or tenant – the other parties will give each other notice and the opportunity to rectify the default before exercising their termination rights under their respective contracts.

Each of these arrangements, in their various forms, are designed to procure project completion, rather than to crystallise the losses by terminating one of the project contracts. The key to keeping projects on track when the main contractor has defaulted is to ensure that the specialist subcontractors and suppliers remain available to complete the work, either under direct appointments to the owner or to a new main contractor through novation.

Requiring head contractors to prove that they are paying their subcontractors and including direct payment clauses, allowing the owner to pay subcontractors directly and then deduct such payments from future payments under the head contract, have become increasingly common. Where the owner has paid the contractor significant sums properly due to subcontractors and suppliers, the owner has an interest in ensuring they get paid; and if they don't get paid, it is not surprising that an owner may wish to keep them on site by paying them directly. Similarly, where a head contractor has gone into liquidation, paying outstanding invoices will typically be a precondition to any novation.

2. *Pari Passu* Principle

The difficulty with such arrangements is that a payment which is properly due to an insolvent company (in this case, the main contractor), which is paid to a creditor of that company (a subcontractor), regardless of the justification, offends the *pari passu* principle, potentially making it an insolvent transaction, voidable in terms of section 292 of the Companies Act 1993. In such a situation, the owner remains liable to pay the liquidator for the full amount of the invoice, including the amount paid directly to the subcontractors, and the subcontractor payments would be reversed. The invoiced amount then goes into the creditor's pool, and the subcontractors would join with the rest of the unsecured creditors, getting paid cents in the dollar, if that.

The leading case on this issue was the 2015 Supreme Court decision in *Allied Concrete Ltd v Meltzer* [2015] NZSC 7 quoted at the head of this article. In that case, the Supreme Court outlined three prerequisites to avoid repayment:

(a) the recipient of the payment acted in good faith, and

(b) the recipient did not suspect or have reasonable grounds for suspecting that the company (on whose behalf the payment is made) was insolvent, and

(c) the recipient gave value, either by transferring property or foregoing legal rights in the reasonably held belief that the transfer would not be set aside.

The difficulty with direct payment agreements should be apparent – they only become relevant at times of insolvency. A payment, properly due to the head contractor, made by an owner to a subcontractor *because* the head contractor was insolvent, would clearly fall foul of s 292 without the benefit of the defence outlined by the Supreme Court.

3. Court of Appeal provides further clarification in *Ebert Construction v Sanson*

The issue was considered further by the Court of Appeal in June 2017, in the case of *Ebert Construction Ltd v Sanson* [2017] NZCA 239. The case concerned the development of the 134 unit Shoalhaven Apartments complex in Takapuna. The project was developed by Takapuna Procurement Ltd (TPL), with finance provided by BOSI and Strategic; construction was undertaken by Ebert Construction Ltd. Among the project documents was a direct agreement between TPL, Ebert, BOSI and Strategic under which the financiers (BOSI and Strategic) were to make progress payments under the construction contract direct to Ebert on TPL's certification and the financiers were to get certain step-in rights under the construction contract.

In settlement of a delay claim and remaining payments under the construction contract, TPL transferred one of the apartments to Ebert at a discount (to be settled on code compliance certification) and issued drawdown notices to BOSI, totalling $1.6 million. TPL was put into liquidation shortly after these transactions owing money to IRD for GST and to two unsecured creditors. The liquidators sought the repayment of these payments from Ebert as *voidable insolvent transactions* under s 292. In the High Court, Associate Judge Doogue found for the liquidators and ordered the payments to be refunded.

In the Court of Appeal, Kós P gave a useful summary of the history of direct payment agreements, and identified four issues for consideration:

(1) Were the payments made by BOSI transactions by TPL?

(2) Were the payments voidable insolvent transactions in terms of s 292?

(3) Was the apartment transfer an insolvent transaction?

(4) From when should interest run?

Were the payments made "by the company"?

On the first point, the court accepted that the payment wasn't made by the company, as BOSI had a direct liability to Ebert to pay the progress payments – there was privity between BOSI and Ebert, with a direct obligation on BOSI to pay approved payments, independent of TPL's compliance with its loan facilities; that obligation was by BOSI as principal and not as agent for TPL; the obligation to Ebert was independent of the provisions of the loan facility agreement; at the time of the payments, TPL was already in default of the facility and BOSI would not have permitted, nor been obliged to make, those payments to the other creditors; and for a payment to be "by the company" for the purposes of voidable insolvent transactions, the funds had to come from resources available to the other creditors.

While Kós P makes the point that the substance of the transactions is more critical than their form, it is hard to get away from the point that the funds were only available to Ebert as a result of TPL's loan facility. However, as the obligation was direct from BOSI to Ebert, and was independent of TPL's loan facility agreement, the message is reasonably clear for contract drafters – BOSI gave a commitment to Ebert to pay approved amounts as consideration for the direct agreement, and more critically the drawdowns would never have been available to the creditor pool.

Were the payments voidable insolvent transactions in terms of s 292?

On the second question, the court held that as Ebert would have been entitled to recover the approved amounts from BOSI directly, whether before or after the liquidation; it would not have bothered with the general pool as it could claim directly; the payments did not, therefore give Ebert a preferential position over other creditors; and therefore it was not a transaction to which s 292 applied.

Was the apartment transfer an insolvent transaction?

On the question of the apartment transfer, the court found that the conveyance of the apartment was a transaction to which s 292 applied, however when the agreement was entered into (in October 2006), TPL was not insolvent and, among other reasons, the net effect of the transaction was not to give Ebert more than it was entitled to after the liquidation – it had an equitable right to complete the transaction post liquidation.

The question of interest, therefore, did not arise.

4. Conclusion

The case raises a word of caution in relation to direct payment provisions in contracts and in novation agreements.

While it is clear that a direct payment agreement, creating a freestanding obligation on financiers to make progress payments directly to contractors, would be independent of the owner, where an owner makes a direct payment to a subcontractor, it would more clearly be making that payment on the contractor's behalf. If the payment is made during the two year period preceding the liquidation of the main contractor, such a transaction could well be caught. As this scenario is most likely to arise when the main contractor is insolvent, and therefore not making payments as they fall due, this risk cannot be understated.

Conversely, if owners (and their financiers), in consideration for the subcontractor's agreement to novation of their subcontracts, accept a direct obligation to pay subcontractors, as guarantors, in the event of default by the main contractor, provided the obligation was unequivocal and enforceable independently of the main contract, it is likely that the payment would not be made "by the company", and therefore s 292 would not apply.

This position would, of course, be strengthened if direct payment of subcontractors was built into the construction contract, as with construction management projects, and the contractor was paid only its margin or management fee, rather than getting the benefit of cashflow from payments it was not strictly entitled to retain.

The alternative, of significant project payments going into the creditors' pool for disbursal to subcontractors and suppliers on other projects is far more sobering.

The case is on appeal to the Supreme Court.