Security for payment from principals

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During difficult times, it is important that contractors seek to ensure they have security for payment from their clients. Popular methods used in the market for obtaining security are through the use of instruments such as bonds, parent company guarantees (PCGs) and escrow deeds.

There is no one perfect solution for contractors seeking payment security from their clients, but there are a number of options that can help reduce the financial impact if the principal fails to pay

None of these types of security are 'cure-alls', but they can help to reduce the financial impact faced by contractors in a situation where a principal fails to make payments under a contract.

A note of caution: to be able to require a principal to provide performance security will mean that appropriate contract terms need to be in place from the outset.

WHY SECURE PAYMENT?

Payments owed by principal clients to contractors will usually be unsecured. This means that a contractor's claim to funds owed may be trumped by an insolvent principal's bank, or other preferential (secured) creditors. It will almost always be a condition imposed by a bank lending to a principal that the bank takes a 'security interest' over the principal's assets.

The bank's security interest is registered on the Personal Property Securities Register (PPSR). Security interests that are registered on the PPSR will usually trump an unregistered (i.e. unsecured) interest, such as a contractor's claim for payment due under a contract.

In a liquidation, the Companies Act 1993 also sets out a list of other types of creditors that are also likely to be paid before contractors, such as the insolvent principal's employees.

IDENTIFYING THE PRINCIPAL

Before deciding on a form of security, it is important that contractors clearly identify who the principal is that they are contracting with. This sounds simple, but the process of identifying the particular entity entering into a contract can often seem to be an exercise of navigating through smoke and mirrors.

Once this is established, the principal's financial standing should also be established to ensure that entity has the capability to make payments that will arise under the contract. Contractors should be especially aware of 'special purpose vehicles' or shell companies incorporated by the principal specifically for the project, but which have no assets.

PARENT COMPANY GUARANTEES

If contractors are concerned about the principal's financial standing, contractors should consider asking for a guarantee from the principal's parent company (or ultimate owner) to protect the contractor in the event of a principal's default. At a high level, parent company guarantees (PCGs) are a contract where the parent company agrees to step in and answer for the debt of its subsidiary if the subsidiary fails to pay.

PCGs can be useful where the principal is part of a large, financially stable group of companies, and the financial substance of the relevant subsidiary (i.e. the principal) is open to doubt. PCGs provide an alternative avenue for debt recovery for the contractor, are well understood in the marketplace, and are relatively quick and cost-effective to enforce.

BONDS

A bond is a financial instrument which enables the beneficiary (i.e. the contractor) to obtain payment directly from the issuer if certain circumstances are met. The issuer will usually be a bank or an insurance company who agrees to pay out a certain specified amount to the beneficiary, subject to the terms of the bond.

It is not unusual for contractors to provide a performance bond to give the principal confidence that the contractor will complete the contract. In the situation where security is being sought from the principal for the contractor's benefit, a principal's bond is issued by the principal's bank (or insurer) in favour of the contractor to ensure that the principal will pay for the work done by the contractor.

When considering a principal's bond, it is important to understand whether the bond will be 'on-demand' or 'conditional'. The key difference is that an on-demand bond can be 'called' by the contractor immediately following any non-payment without having to satisfy any conditions, whereas a conditional bond may require a third party, like the engineer to the contract, to give their approval prior to the contractor being entitled to call on the bond. Ideally, contractors should seek to hold on-demand bonds that may be called as soon as payment is overdue under the contract.

Bonds are often considered more reliable when compared to PCGs as access to the funds is generally faster, but bonds may have a limited duration and provide for recovery of sums up to a certain capped value, whereas a PCG generally covers all obligations of the principal.

ESCROW DEEDS

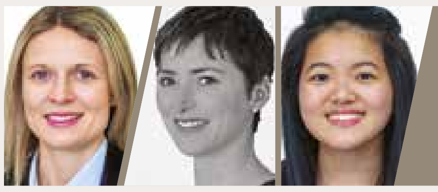
An escrow deed is a deed entered into by the principal, the contractor and a third party (the escrow agent). This deed provides that the principal will pay a sum of money to the escrow agent to hold on trust, and pay to the contractor when specified conditions are met (such as a failure by the principal to make payments due under the contract). Once the contract is completed, the escrow agent would then release the funds back to the principal, if they have not been called upon.

Using an escrow deed can give a contractor confidence that there is an available fund out of which it will be paid if the principal fails to comply with its payment obligations. As a general guide, contractors should ensure that the amount held in the escrow fund will be enough to cover a minimum of two months' work at the peak of construction – to cover the amount outstanding under the previous month's payment claim and the work being done in the current month that is still unpaid.

CONCLUSION

There is no one perfect solution for contractors seeking payment security from their clients, but using one of these options could help to reduce the financial impact to the contractor if the principal fails to pay, or becomes insolvent. They can be very effective and do not need to be expensive.

Contractors need to be vigilant about protecting their commercial interests in the pre-contract stage as after the contract is signed, the opportunity to secure security for payment will be much reduced, or even lost.



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