



Contractor Liquidations.

Best practice management of contractor liquidations – what to do when a Council contractor goes bust (and how to set yourself up to manage it)

When a head contractor is unable to complete a project due to liquidation, the consequences can be severe and widespread. Principals (including councils) may face unfinished projects, additional costs in hiring a new contractor, angry subcontractors, media scrutiny and other challenges. Unfortunately contractor liquidation is always a possibility (particularly in this economic climate), but there are strategies available to mitigate the negative effects.

Before liquidations – early project

The contract terms agreed to at the outset of a project can have a huge impact on a principal's ability to manage a contractor liquidation later in the project.

- Consider negotiating for broad rights of set-off and recourse to security, because if a contractor becomes insolvent there will almost invariably be a damages claim in the principal's favour (and security held is likely to be the only thing the principal will be able to actually obtain if the contractor enters liquidation).
- Consider including a right for the principal to take work out of the contractor's hands in circumstances like:
 - suspension of work by the contractor (other than where the contractor is entitled to suspend under the contract);
 - contractor insolvency/administration (where termination is not possible due to legislative prohibitions of reliance on ipso facto clauses); and

- most importantly – where urgent work needs to be done for safety reasons or community use, but the contractor either is not or cannot do that work. This is particularly relevant for councils, since they are responsible for public infrastructure.
- Ensure it is clear in the contract that withholding payment due to subcontractors' charges being received (as required by the relevant legislation) does not constitute a failure to pay.
- Consider obligating the use of a project trust. The project trust regime under the Building Industry Fairness (Security of Payment) Act 2017 (Qld) works by requiring all payments to a head contractor to be made into the project trust account, the head contractor to pay all subcontractors out of that project trust account, and then the head contractor being able to pay itself out of the remainder. This won't necessarily prevent a head contractor liquidation, but it may help subcontractors on the project to be paid, which can help public opinion of the project.

Currently project trust accounts are obligated for eligible contracts by private sector entities, local governments, statutory authorities, and government-owned corporations valued at \$10M+, but that threshold is scheduled to lower to \$3M+ on 1 March 2025, and to \$1M+ on 1 October 2025.

There's also nothing stopping the parties to a contract from contractually agreeing to use the project trust regime before then. Keep in mind though that it may increase the project's administration costs, and the required use of a retention trust account will slightly affect how retention monies can be accessed.

Before liquidation – when you start to see issues

As the project is underway, keep an eye out for things like:

- subcontractors not being paid;
- unexplained delays;
- increased or unjustified variation claims; or
- requests for payments to be front-loaded, with those amounts to then be accounted for with decreased claimed amounts later.

Each of those could be signs that a contractor is having some financial difficulty. If you think that could be the case we recommend the following.

- Identify any urgent work that might need to be quickly taken out of the contractor's hands if they stop being able to do that work (but ensure that you do not repudiate the contract).
- Carefully consider all payment claims, extension of time claims and variation claims. While many contracts specify that all payments are on account, once a contractor enters liquidation it will be very difficult to claw any overpaid amounts back.
- Continue ensuring you comply with all your contractual obligations – you do not want a breach of the contract by you (e.g. by delayed payment which is not contractually justifiable) to be the cause of a contractor liquidation.
- Seek legal advice on all of the above – especially because the risk of repudiating the contract (even inadvertently) is significant.

Post liquidation (short-term)

Once a contractor enters liquidation or another form of external administration (each of which may have different effects, so will need to be considered on an individual basis for each contract and each possible scenario), you may need to move quickly to take any number of the below actions.

- Take any steps necessary to take urgent work out of the contractor's hands (if you are contractually entitled to do so), and have another entity to do that urgent work.

- Possibly terminate the contract. Sometimes it might be necessary to do this quickly in order to take urgent work out of the contractor's hands, but sometimes it shouldn't be done immediately (often so that the principal can contractually have recourse to security before terminating). Depending on the form of administration you also may not be immediately entitled to terminate.
- Consider issuing media releases to manage relations with subcontractors and the public (depending on the profile of the project and of the company in liquidation).
- Consider what you need to do to have recourse to security, and take those steps. You may need to take certain steps before terminating the contract.

We strongly recommend seeking legal advice at this stage to assist with evaluating the options available and ensure you can access any entitlements you may have under the contract.

Post liquidation (medium – long term)

As time goes on, you will need to turn your mind to how to complete the project which the contractor in liquidation was completing. We recommend seeking legal advice to ensure that you can procure a replacement contractor as quickly as possible to minimise the damage caused by delays. Local government principals will still need to ensure that any procurement process is robust, defensible, and compliant with legislative and policy-based obligations (but there may be exceptions to the usual procurement requirements which apply due to urgency or the unique circumstances of re-procuring for a partially completed project).

If you haven't already, you will need to terminate the first contract before engaging a replacement contractor otherwise you will repudiate the first contract (which you definitely should avoid). Contract termination is a high risk action so we highly recommend seeking legal assistance to do so.

The contract used with the incoming contractor will also need to account for the fact that the works have already been partially completed by a different party. The incoming contractor is unlikely to take responsibility for defects or non-compliances in work done by the previous builder, but principals should still try to limit additional liability for delays or variations caused by the new contractor uncovering defects or non-compliances after the new contract is entered into. It can be sometimes be useful to do things like giving tenderers the opportunity to inspect the existing works in detail and then tender on that basis.

You should also:

- expect to receive, and need to respond to and comply with, subcontractor's charges and subsequent claims commencing legal proceedings to enforce those subcontractor's charges;
- keep in mind that once it is known what amounts remain payable to the contractor in liquidation after accounting for your damages (if there is any left), you will likely need to pay those amounts into Court for the subcontractor's charges; and
- consider lodging a proof of debt in the liquidation for your damages.

Conclusion

The Muscat Tanzer team has extensive experience in assisting both public and private principals with managing contractor liquidations as efficiently as possible. We are also very happy to discuss these kinds of issues over the phone at any time without any obligation to continue with obtaining substantive legal advice.

If you would like to know more about how to best manage contractor liquidations and what to do when a contractor enters liquidation, we will be conducting a free online seminar via Microsoft Teams on Wednesday 28 August as part of our Government Seminar Series.



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