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Insolvency

Subcontractors' Charges:
Plenty of power but watch
the fingers!

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Subcontractors' Charges: Plenty of power but watch the fingers!

A subcontractors' charge is a powerful tool in any tradies' toolbelt. However, as with most power tools, a charge can be dangerous in the wrong hands.

A charge is a means by which a subcontractor can recover a debt owed by a builder for building works. When correctly used, it can help a subcontractor to bypass a floundering builder (the contractor) and recover monies owed to it directly from the developer who engaged the builder to perform the building works.

A charge is, in every respect, a genuine security interest. However, it attaches to only one asset of the builder - the builder's right to receive payment from the developer. Once established, a charge will afford the subcontractor a priority claim against this asset. A charge can even triumph over a fixed and floating charge that has been previously registered over the builder's assets in favour of a bank or other secured creditor, so that the secured creditor's rights are secondary to those of the subcontractor.

Charges are governed in Queensland by the *Subcontractors' Charges Act 1974*. The drafting of the Act has been frequently criticised by the judiciary to the point where it was once described as one of the most difficult and unworkable pieces of legislation ever conceived. It is riddled with numerous pitfalls for the unwary.

In particular, issues will arise when the builder or developer is insolvent, and either bankrupt (as an individual) or externally administered (as a company). For the purpose of this paper, we will focus on circumstances in which a corporate builder (as is most frequently the case) is insolvent and externally administered pursuant to the *Corporations Act 2001*.

Notice of Claim of Charge

If a subcontractor has not been paid, the first step is to serve a Notice of Claim of Charge, which empowers the subcontractor to assert a charge on certain monies (including retention monies and any security monies) payable under a contract with the builder.

It is crucial that the notice is properly drafted and correctly identifies the parties and the subject matter of the charge. The subcontractor also needs to ensure that the notice is given within the requisite time frame, which is generally three months from the completion of works, expiration of the maintenance period, or expiration of the release period. Courts have likened the subcontractors' charge to a floating charge, which crystallises when the notice is served.

It is important that the subcontractor fully considers the payment provisions in the contract when serving a charge. In *Mulherin Rigging & Cranes Australia Pty Ltd v Roberts & Schaefer Australia Pty Ltd*, the plaintiff was forced to amend the amount sought in the charge to include sums to be paid on account of GST. The Court held that commencing proceedings to enforce the charge for an amount less than the total sought did not bring about the partial extinguishment of the charge. The Court also held that, although the original amount sought in the charge did not deal with GST, it was clear that there was an obligation to pay GST under the contract. In the circumstances, GST was construed as money payable, and the subcontractor was entitled to claim GST - which could be the subject of a charge.

Importantly, a notice can be served by a subcontractor after the external administration of the builder (either administration or liquidation) has commenced.

It is often the case that creditors are oblivious to the financial difficulties of the builder until after a formal appointment has occurred. Unlike any other creditor, the subcontractor can effectively convert its status from "unsecured" to "secured" after the formal insolvency administration is up and running by serving a notice. The subcontractor is not treated as a secured creditor over the assets of the builder generally - the security only attaches to the builder's cause of action against the developer.

Serving the notice is just the start of the recovery process for the subcontractor. There are some obstacles to be faced along the road to recovery.

Proceedings to enforce charge and leave to proceed

Under section 15 of the Subcontractors' Charges Act, a subcontractor must begin legal proceedings to enforce the charge within one month after notice has been given, and no later. If the subcontractor fails to do so, the charge is automatically extinguished.

Care must be taken in determining when that critical limitation period will come to an end. In *State of Queensland v Walter Construction Group Limited*, the Court found that where a subcontractor gave a notice during the period of the builder's voluntary administration, the subcontractor was temporarily prevented by the Act from beginning proceedings to enforce the charge. As a result, the one month limitation period did not start running until the administration had finished.

The suspension of the one month limitation period will only apply in a voluntary administration (not where the builder is in liquidation). Therefore, time will start running (or perhaps resume running) if the voluntary administration converts into a liquidation on the strength of the votes of the creditors at the second meeting convened by the administrators.

Therefore, a voluntary administration is a "wait and see" event for the subcontractor. All the subcontractor can do is serve the notice and wait for the insolvency administration to move to the next phase.

Once the builder is in liquidation, or perhaps has become subject to a Deed of Company Arrangement, the subcontractor will require leave of a Court of competent jurisdiction to begin the legal proceedings that section 15 requires it to commence in order to keep its charge alive. Leave can be sought retrospectively, but the sensible approach is to obtain leave before beginning proceedings.

There is a line of authority in Queensland that suggests that leave to proceed against the builder is usually granted. For example:

- In *Ex Parte Pavex Construction & Ors*, the Court confirmed that there was nothing in the *Companies Act 1981* (the corporations legislation in force at the time) that prevented a subcontractor from obtaining security under the Subcontractors' Charges Act, even though the subcontractor did not take steps to do so until after the winding up of the builder had started.
- In *Ex Parte S C Upton & Sons Pty Ltd (In Liquidation)*, the Court found that leave to proceed was necessary and granted this leave, stating that it was a "most suitable case in which leave should be granted".
- In *Re: Hewson & Douglas Pty Ltd (In Liquidation)*, the Court granted leave to proceed, and noted that it was a "typical case in which leave is usually granted".

However, having leave granted is by no means a foregone conclusion. For example:

- In *Re Galaxy Investments Pty Ltd (In Liquidation)*, the subcontractor was unsuccessful in obtaining leave to proceed to enforce the charge retrospectively. The Court found that the notice had not been properly given in accordance with the Subcontractors' Charges Act, but also found that the proceedings that it had started were not "commenced to enforce the charge" because the proceedings (as drafted) failed to make out the claim.
- In *Re QMT Constructions Pty Ltd*, an application for leave to proceed against a company that was subject to a Deed of Company Arrangement was refused, again because the proceedings begun by the subcontractor were (as drafted) not sufficient to enforce the charge. However, the Court noted that, as bringing proceedings was the only effective way of enforcing a charge, the Court should ordinarily grant the holder any necessary leave to do so.
- In *Re Summit Designs & Construction*, the Court granted leave to the subcontractor to begin proceedings in relation to only one invoice of three that were unpaid, because the developer had paid the other invoices to the builder.

As the decision in *Summit* demonstrates, a charge only attaches to money that is payable by the developer to the builder. Subcontractors will often be unsure whether the developer has made payments to the builder, and should make

enquiries if possible to determine whether there are any monies to which the charge can attach. Courts are unlikely to grant leave to proceed in circumstances where doing so would ultimately be a pointless exercise.

Subcontractors must also ensure that the Notice of Claim of Charge and proceedings commenced to support the charge are accurate, and plead all necessary matters to enforce the charge. Failure to do so will result in an otherwise valid charge being quashed.

After proceedings commence

Even after proceedings to support the charge have commenced, payment to the subcontractor is not guaranteed, and the subcontractor may face some formidable obstacles. It is possible for the builder and/or the developer to defend the claim on numerous grounds, including grounds based on any offsetting claims that the developer may have against the builder.

The charge is only as strong as the builder's claim against the developer. The developer may refuse to pay the builder for any number of reasons, such as:

- defectiveness of the works;
- the insolvency of the builder amounting to a breach of contract, giving rise to significant loss and damage (typically because the builder cannot complete the works and a new contractor must be retained); or
- other breaches of contract.

There is no point lodging a charge unless these issues have been carefully analysed and the subcontractor has a realistic basis to expect that the developer is liable to pay money to the builder for the building works.

In practice, once it accepts liability to pay the builder, the developer will often pay any money to which a charge may attach into Court, as this satisfies its obligations under the Subcontractors' Charges Act. This will excuse the developer from further participation in the litigation. It is then up to the subcontractor to take steps to have the money released to it, and to resolve any dispute with the liquidator or deed administrator.

Other pitfalls

Unfortunately, there are a number of other pitfalls awaiting a subcontractor who has come this far down the rocky road to payment.

First, if the builder is insolvent, there are often other unpaid subcontractors who are equally anxious to be paid - and equally entitled to lodge a charge. If multiple charges are lodged, each subcontractor will share equally in the money in proportion to their claim. In essence, the subcontractors receive a pro rata share of the money payable to the builder in proportion to their debts, and receive no priority for having lodged their charge earlier than other subcontractors.

Second, subcontractors can suffer an unwanted side effect of lodging a proof of debt or voting as a creditor of the builder. In *Seventeenth Canute Pty Ltd v Bradley Air Conditioning Pty Ltd (In Liquidation)*, the Court held that a subcontractor who has a right to assert a charge can forfeit this right if it lodges a proof of debt under a Deed of Company Arrangement, unless it makes it clear that it is only proving for the unsecured portion of its debt. Further, if the subcontractor votes in favour of the Deed of Company Arrangement, it may be taken to have waived its charge.

Third, a subcontractor who chooses to pursue its claim as a secured creditor of the builder may miss out on benefits that are specifically given to unsecured creditors pursuant to a Deed of Company Arrangement. In *Re Stockport (NQ) Pty Ltd*, the Court found that subcontractors who had given notice and had not voted in favour of a Deed of Company Arrangement were entitled to enforce the charge, and were not prevented by the deed from realising their securities. However, the Court also held that the subcontractors were not entitled to receive a distribution from the deed fund for any shortfall in the security as they were not "contractor creditors" as provided for in the Deed of Company Arrangement.

A subcontractor who lodges a charge should bear in mind that as a secured creditor, he or she ought to act like one to be treated as one.

While it's a powerful tool, a subcontractors' charge needs to be handled with care. It is always best operated by a professional.

If you have any questions about subcontractors' charges, please contact HopgoodGanim's Insolvency or Construction, Infrastructure and Major Projects practice.

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