

# REGULATORY IMPACT STATEMENT

## STATEMENT OF THE PUBLIC POLICY OBJECTIVE

1 Currently subcontractors in the construction industry bear the bulk of the risk of non-payment in the industry, yet they have insufficient information and ability to manage cash flow to bear that risk. The key objective of the proposed Bill is to shift the risk of non-payment to those higher in the contractual chain who are considered to be in a better position to manage that risk. Shifting the risk to a group that is able to manage that risk is likely to result in gains in efficiency through reductions in costs of doing business, such as the cost of obtaining finance and insurance.

## STATEMENT OF THE PROBLEM AND THE NEED FOR ACTION

2 Cabinet has already agreed in principle to the enactment of a Bill to address the problem, subject to further work being done on the detailed design of the Bill and further discussions with interested parties [CAB(00) M 30/1F refers]. The Regulatory Impact Statement attached to that Cabinet paper set out the net costs and benefits of such a scheme. For convenience these are reproduced below.

3 This regulatory impact statement concerns those detailed design issues addressed in the Cabinet paper that are of more than a minor or machinery nature or would have a substantial effect on the proposed arrangements.

## STATEMENT OF THE NET BENEFIT OF THE PROPOSED LEGISLATION

### Benefits

4 The benefits of the proposed legislation are that the risk of non-payment would be shifted to those who are best placed to bear it. This would be likely to have the following effects:

- Increased security that subcontractors would receive payment;
- Benefits to employees from increased security for payment of their wages as a result;
- Overall reduction in the costs of doing business, such as raising finance, as a result of increased certainty of payment.

### Costs

5 Potential costs of the proposed legislation are:

- The shift in the risk of non-payment could require those firms higher up the contractual chain to invest more capital early in the project;
- There is a risk that there would be negative impacts on employment opportunities in the construction industry as a result of these proposals if there is a reduction in the level of construction activity due to the changes to industry payment practices.

6 Accordingly, on balance the potential benefits that the proposed legislation are likely to achieve outweigh the potential costs.

## **STATEMENT OF THE NET BENEFIT OF KEY COMPONENTS ADDRESSED IN THIS CABINET PAPER**

### **Application to the Crown**

7 The Bill could be drafted so it does or does not apply to construction contracts entered into by the Crown.

8 The benefits of the Bill applying to the Crown are that the same rules, giving the same benefits, will apply across the whole industry, including the Crown. The desired aims of keeping risk at the top of the contractual pyramid and speeding up payments should be achieved. The adjudication system will be available to the Crown and other parties it contracts with, to facilitate speedy resolution of disputes between them.

9 The costs of the Bill applying to the Crown are that the Crown, like any other person who commissions construction work, will be unable to take advantage of "pay if paid" or "pay when paid" clauses and may be required to invest more capital earlier in any construction activity it undertakes. It may be required to make payments promptly by the adjudication process, rather than waiting for the outcome of court proceedings. This may cause the Crown to be more cautious in planning construction work.

10 Accordingly, on balance, it is proposed that the Bill should apply, because the Crown is, in respect to construction work, in the same position as any other party contracting for construction work to be done.

### **Application to Residential Homeowners**

11 Alternative strategies to address the position of homeowners were:

- a The Bill could apply in its entirety to homeowners.
- b The Bill could not apply to homeowners contracting for work to be done on their homes.
- c The Bill could apply in part to such homeowners. The prohibition on "pay if paid" and "pay when paid" clauses and the adjudication system would apply, but the statute would not impose as default provisions either a right to suspend work or a right to be paid progress payments.

12 Option a was rejected because homeowners were considered to be in a vulnerable position, so they could be significantly disadvantaged if the default provisions in the Bill were applied to them. Option b was rejected because subcontractors still require protection from "pay if paid" and "pay when paid" clauses, regardless of the status of the property owner, and because the adjudication system could offer significant benefits to both homeowners and those in the industry.

13 The potential benefits of option c are that:

- a Subcontractors would be protected from "pay if paid" and "pay when paid" clauses.
- b The adjudication system would give both homeowners and those in the industry a fast cheap method of resolving contractual disputes.

14 The potential costs of option c are that homeowners might have to participate in both the adjudication process and the courts system, causing two sets of compliance costs. There would be slightly increased compliance costs on those contracting with homeowners, who must advise homeowners of their rights when serving notice of a payment claim or of an adjudication on them.

15 Accordingly, on balance, option c is the preferred option. There are sufficient safeguards in the proposed legislation that the benefits of option c outweigh the disadvantages.

### **Enforcement of Adjudicator's Awards**

16 Three options for the enforcement of adjudicator's awards were considered. These are:

- a Automatic recognition of adjudicator's awards, giving them the force of court decisions;
- b Providing a security interest over the property of the principal;
- c Obtaining summary judgment and using the normal court enforcement procedures.

17 Option a was rejected. While this would have saved the time and expense involved in obtaining summary judgment, the informality of the adjudication procedure was considered to be inconsistent with the status of the decisions under such an option. Option a would also have prevented resort to arbitration because arbitrators cannot deal with a matter that has been the subject of a Court decision.

18 Options b and c are outlined in the Cabinet paper. The potential benefits of option b are:

- a That it provides security of payment to subcontractors through a remedy against a party with whom they have no direct contractual relationship.
- b Has the potential to limit the ability of unscrupulous developers to deliberately structure their affairs so as to avoid their liabilities to subcontractors.

19 The potential disadvantages of option b are:

- a That it could increase the cost of construction. Such a remedy shifts the risk to parties who are not necessarily in a position to control the risk and could result in an owner having to pay twice or requiring bonds from those further down the chain to avoid having a security interest registered against their property;

- b That it could undermine the fast track adjudication process. More formality and complexity would be needed in the adjudication process to ensure that the remedy is only used in appropriate circumstances.

20 The advantage of option c is that it would simply utilise existing procedures. As a result it would not create any new risks. A security interest would be available in appropriate situations. The potential disadvantage is that obtaining summary judgment in order to obtain a charging order is likely to take longer than obtaining a security interest directly from an adjudicator's decision, meaning that in some situations there may be no property left for the security interest to attach to.

## CONSULTATION

21 A round of public consultation on the Working Group's report was undertaken in September and October this year with stakeholders within the industry who were not part of the Working Group process, including groups such as financiers and residential homeowners. Responses from those groups were circulated to the Working Group for comment.

<b>Government Agencies</b>	<b>Other Parties</b>
<p><b>Consulted on this Cabinet Paper:</b></p> <ul style="list-style-type: none"> <li>- Department for Courts;</li> <li>- Department of Labour;</li> <li>- Legislation Advisory Committee;</li> <li>- Ministry of Consumer Affairs;</li> <li>- Ministry of Justice;</li> <li>- State Services Commission;</li> <li>- Treasury</li> </ul>	<p><b>In the Working Group:</b></p> <ul style="list-style-type: none"> <li>- Registered Master Builders Federation</li> <li>- New Zealand Building Subcontractors Federation</li> <li>- New Zealand Contractors Federation</li> <li>- Northern Amalgamated Workers Union</li> <li>- Fletcher Construction</li> <li>- New Zealand Institute of Architects</li> <li>- New Zealand Institute of Quantity Surveyors</li> <li>- Independent arbitrators with experience in construction disputes</li> </ul>
<p><b>Responses to consultation on this Cabinet Paper:</b></p> <ul style="list-style-type: none"> <li>- Department for Courts;</li> <li>- Department of Labour;</li> <li>- Legislation Advisory Committee;</li> <li>- Ministry of Consumer Affairs;</li> <li>- Ministry of Justice;</li> <li>- Treasury</li> </ul>	<p><b>Responses received from other agencies in consultation on the Working Group Report:</b></p> <ul style="list-style-type: none"> <li>- Consumers' Institute</li> <li>- Financial Services Federation Inc</li> <li>- New Zealand Bankers' Association</li> <li>- Pavement &amp; Bitumen Contractors' Association</li> <li>- Transit New Zealand</li> </ul>