

Review of methods for mitigating payment risks in construction: The case of New Zealand

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ABSTRACT

Traditional payment methods in the construction industry create risk of payment delays and losses. The issue has been persistent since the early 1960's, with constructions parties suffering dire consequences. Many legislative & contractual, and administrative solutions are in use but these measures have not adequately addressed the payment losses experienced by lower tier parties due to the insolvency of upper tiers, especially losses to contractors due to client insolvency. This paper reviews some of the solutions that could be used to protect against client insolvency.

It is revealed that legal provisions in security of payment Acts cater for losses due to deferred payments but not for insolvency payment losses. Acts provide adjudication for non-payment which is not effective in cases of insolvency when a company goes into liquidation because claimants may not be able to recover monies due. Some of the Acts have abolished contingent payment provisions' while some have counter clauses with similar objectives. However as a contractual solution, the conditions of contract in New Zealand (NZS 3910:2003) enables contractors to obtain payment bonds from clients as security. If a client fails to provide the bond, contractors could terminate the contract at inception.

Other security mechanisms such as Buildsafe security scheme and direct payments are in practice; while potential solutions like bonds and guarantees, payment default or insolvency insurance; registration and prequalification of upper tiers; are in consideration. Further study is needed to assess these solutions in terms of their costs and benefits as viable solution(s) to payment losses.

Keywords: Construction Industry; Payment Risks; Insolvency

1. INTRODUCTION

Payment default is a serious problem in the construction industry of many countries. This could be attributed to the nature, consequences and risk associated with the industry. Payment problems were reported in Banwell (1964) and three decades after, Latham (1994) and Egan (1998) contend that it is still an issue worthy of consideration. Payment delays and losses create problems of cash flow, stress, and financial hardship to contractors (Ang, 2006). Further, it leads to a potentially crippling effect of insolvency. Head contractor's insolvency due to owner's payment default affects other parties in the project chain. The lower parties in the supply chain could be faced with the prospect of losing their money (Euginie, 2006). In China, the owner's payment default is seen as a major obstacle in project execution, it gives a lot of suffering to the contractors and also affects the development of the industry (Meng, 2002). To mitigate this effectively Chinese contract law enables the contractors to establish a legal mortgage, thereby giving contractors strong support to prevent unfaithful owners from delaying payments. In Kuwait, Kartam and Kartam (2001) found that delayed payment is the second highest risk after financial failure that causes project delays. Kartam and Kartam had investigated the level of significance of 26 types of project risk items.

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Thus financial failure is a consequence of payment default because of negative cash flows that could impact on project progress (Akintola and Malcolm, 1997).

Delayed and non-payment risk is primarily due to counterpart's 'cannot', 'would not' pay attitude or both. It is evidenced in large number of construction projects where the owners simply refuse to pay the contractors once the project is completed. For some projects sufficient funding sources are not secured before project start and the contractors often agree to be paid after the work is fully or partly completed (Meng, 2002).

Payment risks may be associated with payment systems and culture within particular construction industries. It is often the case that contractors' payments are settled on an interim basis followed by final payment on completion. It is usual for certain percentage (5-10% of the contract sum), called retention to be withheld until the completion of the project. Thus payment risk results from delayed or non-payment of interim, final or retention sums.

Construction payment-specific Acts and several other contractual and administrative solutions are being implemented in countries like the UK, USA, Australia, Singapore and New Zealand, to mitigate payment risks. However, most of these solutions remedy late payments but fail to provide protection against payment losses to lower tier construction parties where the upper tier experiences insolvency. For example there was a decline in the frequency of late payments since the introduction of the Building and Construction Industry Security of Payment Act 1999 of New South Wales (Brand and Uher, 2008), but the Act is being under utilized by contractors and subcontractors who are the beneficiaries. Similarly in New Zealand, the Construction Contracts Act (CCA) established in 2003 and which replaced the Wages Protection and Contractors Leins Act in 1987, provides little mechanism for losses in insolvency. The New Zealand CCA prohibits conditional payments and provides the statutory right to suspend works due to non-payment. The Act also allows for the speedy resolution of disputes through an adjudication process. Payment losses due to insolvency have become increasingly significant because of the recent economic downturn causing many construction companies to go into liquidation.

Slade (2008) reports that a property developer in New Zealand was declared bankrupt and owed at least NZ\$6 million to creditors, including its design consultants. Another developer is in receivership and liquidation owing NZ\$ 290,000 to the Inland Revenue Department and unsecured creditors about NZ\$ 400,000. In another report (Gibson, 2009a), a company went into voluntary liquidation with 55 claims against it while owing over NZ\$6.5 million. In some of these cases unsecured creditors will most probably not get a cent in compensation.

Having presented the nature of payment risks in construction contracts, the next sections cover a review of the solutions used in New Zealand and other global perspectives in order to see their aptness as a security to payment losses in insolvency situations. This paper is part of a larger study that explores viable solutions to payment risk problems experienced in New Zealand.

2. STRATEGIES USED TO MITIGATE PAYMENT RISKS

This section gives a brief outline of strategies that are in use for mitigating payment risks in the construction industry. Some of the strategies differ from country to country and they range from administrative, contractual to statutory measures. The strategies address the critical risks which causes suffering to construction parties at the lower tier because of the action of the upper tier parties.

Traditionally most of these measures have been used to protect the owners' risks against contractors and subcontractors default. However the recent inclement economic climate has changed situations with the contractors and subcontractors requiring protection from project owners, should the owners' default. Thus, these solutions may require amendment on a case by case basis to incorporate the risks of lower tier parties.

2.1. LEGAL AND CONTRACTUAL PROVISIONS

Brief Review of World Practice

It is of note that most of the developed countries and local jurisdictions have enacted construction payment-specific legislation to facilitate regular and timely payment between construction parties. Some of these legal and contractual provisions are similar, but there are subtleties which are described in the following paragraphs. For example, the UK, and Western Australia (WA) provide statutory payment rights in the absence of contractual rights. While New South Wales (NSW), Victoria (Vict), Queensland (Qld), in Australia and Singapore (Sing) act have payment rights which are applicable along with contractual rights (Bayley, 2007). The latter states have adjudication provisions for disputes that may arise from payment and non-payment issues. Some of the legal documents containing payment provisions in these countries include:

- Housing Grants Construction and Regeneration Act 1996
- Building and Construction Industry Payments Act 2004 (Queensland, Australia)
- Building and Construction Industry Security of Payment Act 2004 (Singapore)

Kansas state in the US enacted legislation called “the Fairness in Private Construction Contract Act in July 2005 to address the problems associated with slow payment, non-payment and out-of state litigation. Unlike in the UK, Australia and Singapore, Kansas legal provisions incorporate contingent payment clause which has no effect on the right of a contractor or subcontractor to file a mechanic’s lien or payment bond claim. The right to file a mechanic’s lien (briefly described below) or payment bond claim can never be waived by a construction contract (Anonymous, 2005).

The mechanic's lien right is one way for a contractor to manage the risk of owner insolvency or failure of payment and used in some Western countries, including the United States, in case of client’s insolvency. The mechanic’s lien gives unpaid contractors a right to place a lien on the property on which the project was built. These rights give the contractor a security interest in the construction project.

The Miller Act is another legal instrument used in the United State to cover subcontractors and suppliers of material who have direct contracts with the prime contractor through a payment bond provision. The payment bond is what differentiates this from the mechanic’s lien. The Act requires contractors who undertake projects exceeding US \$100,000 to furnish a payment bond for the protection of its labour and material suppliers before the contract is awarded to contractor. There is a limit however to the limit of parties covered by the Act. Parties further down the contract chain are considered too remote and cannot assert a claim against a Miller Act payment bond posted by the contractor. The amount of the payment bond shall be equal to the total amount payable by the terms of the contract unless it is prescribed by the client that a payment bond in that amount is impractical, in which case the amount of the payment bond shall be set by the client. The amount of the payment bond shall not be less than the amount of the performance bond.

In Germany, legal provisions require the contractor to assess the enrichment of the client as a result of the building work rendered (Fischer, 2008). This provision contained in its Securitization Act helps to remedy any loss suffered by contractors as a result of clients’ insolvency or late payments.

Probably recognising the seriousness and the extent of payment problems that have hampered the development of the construction sector in China, project owners have to provide contractors a payment security (Heong, 2006). This allows contractors to establish a legal mortgage, thereby giving contractors strong backing to prevent unfaithful owners from delaying payment (Meng, 2002). Such provisions are applicable to projects whose contract value exceeds Rmb 10 million. This form of payment security and the mechanism of its operation need further exploration.

A Review of New Zealand Practice

The Construction Contracts Act (CCA) 2002 is a legal instrument that was enforced in April 2003 following the liquidation of several high profile construction companies. The companies were liquidated because clients' and developers' failed to pay for the works executed by the companies and their subcontractors. The CCA facilitates regular and timely payment between project parties by prohibiting conditional payment provisions (in particular pay-if paid and pay-when-paid clauses) (s 13) and adjudication as a speedy disputes resolution mechanism. The removal of conditional payment provision enables subcontractors, sub-subcontractors and suppliers to get paid by head contractors whether or not the head contractor is paid by the principal. As per Section 13 of the Act, conditional payment provision has no legal effect and may not be used as a basis for withholding progress payments that are due and payable under the contract. Thus the principal's insolvency should have no effect on subcontractors' payment but practically it affects the payment of subcontractors and supplies due to tripling effect.

Traditionally CCA sets out a mechanism for claiming any amounts due under the Act by serving payment claims and payment schedules. These provisions have fundamentally changed the way that cash flows in the industry and creates rights and obligations on parties which were not previously in place. If a party fails to provide a payment schedule within 20 working days (or such other time as may be agreed in the contract conditions) the claiming party is entitled to recover the full amount of its payment claim as a debt due (including its associated costs). The claiming party can proceed straight to court to recover the debt due.

CCA provides a party to a construction contract the right to refer a payment dispute (or non-payment) to adjudication (s25 (1) (a)). Adjudication process takes as little as 6 weeks to conclude and provides a cost effective and timely option for all parties involved in construction disputes and that determination is binding on the parties. The Act also provides a statutory right to suspend works due to non-payment. However, in the case of a residential contract, there is no right of suspension of the works. The party who suspends the work has to seek for adjudication or any other dispute resolution mechanisms to claim payment for work done and any retention money withheld by the client before suspension. There is anecdotal evidence to suggest that some clients refuse to pay the amount and could engage other contractors to execute the works. It would seem that there is no security to protect the loss in these instances.

CCA does not interfere with contractual right for payment but provide statutory rights for payment in the absence of any contractual right. This enables parties to claim payment even if there is no contract between parties. On the other hand, if the standard forms of contract have any strong/viable provision to secure parties at lower tiers against the insolvency of upper tiers, lower tiers are guaranteed for payment even if the CCA fails. Thus it is recommended that standard form of contracts should incorporate better mechanisms for insolvency losses.

New Zealand standard forms of contract

Common form of construction contracts used in New Zealand include the NZS 3910:2003, NZS 3915:2005, NZIA SCC1, Standard Master Builders Contract and other forms. These form of contracts incorporate basic guidelines and procedures for payment and payment schedules to parties to deal with payments smoothly. Contractors have a right to serve the progress and final payment claim for work done within a specified time period. If the principal fails to issue a payment schedule and subsequently fails to pay the scheduled amount by the due date, the contractor is entitled to interest, compounding monthly on the scheduled amount from the date on which it would have been payable if the delay had not occurred.

In case of progress payments the principal retains a certain percentage of the amount payable to the contractor and releases them in three stages thus:

- after the issuance of a certificate of completion
- after the of defects liability period, and
- 10 days after the date of the issuance of the defects liability certificate.

Alternatively, contractors can provide a bond in lieu of retentions, called retention bond, along with other bonds required by the contract and in that case the bond will be released only after the issue of defects liability certificate.

The NZS 3910:2003 provides under special conditions clauses to use a payment bond as a security for principal's payment obligations. This could be used as a best way to deal with principal's insolvency risk. The amount of the bond could be as stated in the special conditions or approved by the contractor. Principal and principal's surety are released from this bond within 5 working days after the receipt of final payment as per the final payment schedule. This could also be after payment as per an Arbitrator's award in case of dispute on final payment schedule. If a principal fails to pay the contractor the amount due under any payment schedule; obstructing the issue of any payment schedule; principal bond is not executed and delivered to the contractor within the required time; and the principal becomes bankrupt or going into liquidation; the contractor can notify the Engineer and if the principal's default is not remedied within the specified time contractor can suspend the work and subsequently terminate the contract.

2.2. OTHER ADMINISTRATIVE MEASURES

Review of Possible Administrative Measures

Maintaining a separate escrow bank account

It is usual in liquidation to give preferential treatment to creditors with the available assets of a private client while unsecured creditors are left with nothing. Maintaining a separate escrow bank account to hold the construction contract monies, especially final payment and retention money because they are at the risk of client's insolvency, is desirable. However in insolvency, progress payments have the tendency to be lost or delayed than the final payment.

This account could be in the joint names of the client and the contractor and could be set up in such a way that funds would be held in escrow and would not form part of the client's assets for liquidation purposes, although interest on progress and final payment could accrue to the client.

It is essential to have two separate accounts for progress/final payment and retention money as the amount and releasing time is different. In the case of progress/final payment the amount could be equivalent to final account value or an amount agreed by the parties while for retention as per the contract. The money lying in the accounts could be released once the purposes are served.

Bond and guarantees

Bond and guarantees could be considered as a useful means for creating financial security against client's payment default or insolvency risk. The following bonds and guarantees could be used:

Payment (insolvency) bond: This is a type of bond where a client provides a payment bond to a contractor to ensure payment in case of insolvency. The value of the bond could be equivalent to either two progress claims, because it is usual for contractors to work for 1-2 months in advance without payment. Payment bond could be provided at the beginning of the contract in order to avoid the contractor's failure to perform the work due to client's failure to submit the bond.

Advance payment bond: Traditionally most of the South Asian countries contractors are given an advance payment, within a fixed period of time following commencement of the contract, of 10 to 20

percent of the contract sum. An advance bond is used as a security for the client to recover any advance payment from the contractor if the contractor fails to perform its obligations under the contract. Advanced payment bonds could be used as a risk mitigating mechanism of contractors due to owner's payment default or insolvency risk. Clients could provide the contractor an advance bond as security for insolvency risk. Advance bond usually contain a recovery clause whereby the amount of bond is reduced from the progress claim but when it comes to insolvency security, the bond can be released once the contractor's final account is settled.

Retention bond: Retention monies are normally viewed as a security for the cost of rectifying defective works. The money is retained as a fixed percent from every progress claim totalling to the amount stipulated in the contract and released in two stages after the practical completion and defects liability period. This way of retaining the money could be replaced by a bond which will ensure the security of retention money in case of client's insolvency. The bond could be submitted at the beginning of defects liability period and released after the completion of the defects liability. The release of performance bond by client could be made conditional upon the submission of a retention bond.

Owner's payment guarantee

Contract guarantee is a risk-transfer mechanism designed to protect creditors from losses due to a debtor's default. In contract guarantee, three party relationship, the surety lends his or her good credit to the debtor and guarantees the debtor's proper performance to the creditor. In case of the debtor's failure, the surety assumes the debtor's obligation to the creditor. Before issuing a guarantee or a bond, the surety will carefully evaluate the debtor's financial status, technical experience, management capability, and performance record for the purpose of prequalification. Owner's payment guarantees are being implemented in China for construction projects financed in whole or in part by loans from the World Bank.

Registration and prequalification of construction parties

The registration and prequalification of construction parties could be used as a mechanism to prevent losses by parties from the upper to lower tiers. The nature and the characteristic of the construction industry is such that it has absolutely no barriers to entry thus companies or individuals with no capital base and very limited experience are able to set up construction business. Even worse, individuals associated with companies that have gone bankrupt and had questionable business practices are able to re-establish themselves a day after they have gone bust. Thus payment risks could be minimised if it is made mandatory requirement by an Act or contractual conditions for construction parties to be qualified on the basis of financial viability before undertaking any project. This is particularly important for project owners and main contractors.

Companies could manage themselves against the risk of owner insolvency or non-payment by working for very rich owners. Though contracting with a very rich owner is not a guarantee of payment because the seemingly rich owner may have financial problems. In this situation, however companies could pre-assess clients for their financial status, and creditworthiness. If it is adjudged that the client is likely to become insolvent, a contractor could request adequate security such a client.

Payment default or insolvency insurance

Similar to other insurance policies contractor can obtain payment default or insolvency insurance coverage for protection against client's insolvency. If the client fails to provide any security, contractors could use this as a last resort for protecting themselves from client payment default insolvency.

A Review of New Zealand's Administrative Measures

The BuildSafe Security of Payment Scheme

BuildSafe security of payment scheme was recently formed in September 2009 as an independent and external private security of payment scheme to protect construction parties from their counterparts. It protects owners from losing money in over-claims by contractors, defective work, and going into liquidation, while it protects contractors from delayed payment, especially final payments by client. It secures subcontractors or specialist trade contractors from non-payment for work they have done or materials supplied. Buildsafe security has been developed specifically for the residential house and light commercial building construction market in New Zealand.

Under the BuildSafe security of payment scheme, BuildSafe security holds an amount of money, security amount, paid by a project owner. The security amount is calculated to be roughly the equivalent of the deposit required by most contractors under typical building contracts. That amount is roughly equivalent to any final payment due to the contractor under the contract. The security amount is held in trust by Buildsafe security until the contractor has performed its obligations under the contract. Buildsafe security releases the security amount to the contractor and subcontractors as the case may be, and the service is completed. Of course, if the contractor fails to perform its obligations, the money will be given back to the project owner.

The owner is protected by not having to pay the contractor a deposit at the start of the project at such time as there is little or no work in place and the contractor is protected by knowing that the security amount is available to meet any payment claim in respect of which the project owner may default.

To safeguard parties, all payments into and out of the trust account are subject to the scrutiny and approval of an independent custodian, perpetual trust. Buildsafe provides fair formal conditions of contract that operate by default and a fair payment regime that operates notwithstanding any other agreement the parties to a contract may have made.

Buildsafe also provides parties with the tools to assist them to contract sensibly and safely in accordance with best practice. This minimises the chance of costly and destructive disputes occurring on a project. Buildsafe is partnered with the Building Disputes Tribunal to back up and support the scheme by providing specialist dispute resolution procedures and to ensure that any disputes that do arise, are resolved fairly, promptly and cost effectively.

Direct Payment Agreement

In New Zealand direct payment is considered as a mechanism which has saved the industry from company failures and ensured that banks have completed assets. Direct payment agreement ensures builders can get their money from a secured source which is usually a bank rather than a developer. It seems the scheme has increasing patronage in New Zealand. "Given the number of developers that have gone under if contractors were operating in the old manner where banks pay the developer and developer pays the builder, it would have potentially pulled building companies under and caused subcontractors a lot of cash flow issues" (Gibson, 2009b).

3. DISCUSSION

In general legislation in most countries have got powerful provisions for statutory right for payments and adjudication of payment disputes. These legislations cover contracts that are written, oral, partly written and oral, and allow either party to contract to refer the disputes. Adjudication periods are usually limited to 20 working days and further extendable with consent. It is anticipated that legislation would eliminate disputes or lessen issues related to payment in construction projects. However, evidence from New Zealand show that the number of court cases increased rapidly since the introduction of the CCA in 2002. This is depicted on Figure 1.



Figure 1: Number of court cases from 1984-2009
(Source: Choi, et al., 2010)

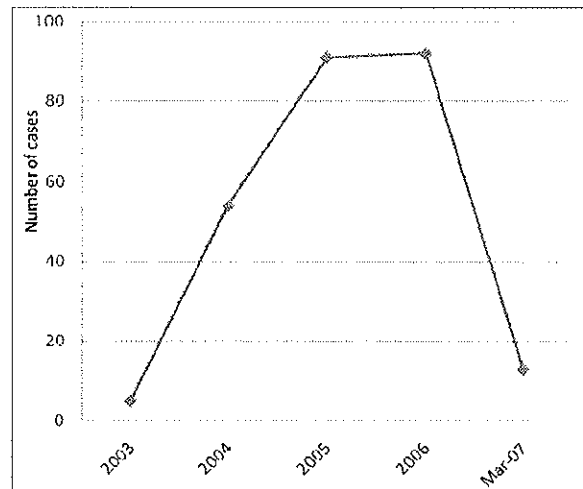


Figure 2: Number of adjudications from 2003-2007
(Source: Bayley, 2007)

On a similar note, the number of adjudications applications to the authorized nominating authority (ANA) increased over the same period reaching a total of 264 in 2007 (see Figure 2). It would seem that the CCA improved the payment culture, but is still under utilized by the main beneficiaries (contractors and subcontractors) of the legislation.

Payment risks depend on the nature of the industry and its' payment culture. Traditionally the industry has less capital backing it, but companies with little capital are able to transact business. This could be improved if it becomes a statutory requirement for clients and contractors to be qualified on the basis of their capacities to undertake certain category of projects. Payment delays and losses may be attributed to contractors as well. Often contractors agree to be paid after the work is fully or partly completed. Contractors choose not to take action against project owners because of future job prospects in exchange of deferred payment or payment of lesser sums. Further, contractor and subcontractors in construction have little or no bargaining power whereas clients capitalize on this to refuse or delay payment after the work has been done.

Third party guarantees in the form of bonds and guarantees on the other hand, could be considered a viable solution because they could allow construction parties to transfer financial risks to third parties. This is the primary reason behind federal and state governments' requirements for contractor performance and payment bonds (Hansen, 2004 and Bausman, 2009). In obtaining either a payment or advance bond it could be repudiated by a client as issuing bonds and guarantees involve bank, surety companies, and insurance companies to prequalify the clients for his payment, performance history as well as financial stability. Alternatively if it is made a regulatory requirement for clients and contractors to be qualified and certified to undertake certain project categories, the issues around the obtaining of bonds and guarantees could be avoided. Conversely, there could be a system where the construction industry could set up a common contract guarantee fund which allows construction parties to get bonds and guarantees at a concessionary rate.

If a project owner fails to provide a security in the form of a bond or a guarantee at his own cost, contractors may have to obtain a principal's payment default or insolvency insurance and try to incorporate the cost into overheads. This cost will be reflected in the contract figure, and ultimately this is taken up by the project owner.

4. CONCLUDING REMARKS

Though many countries have established and are implementing several schemes to secure payment to lower tiers due to insolvency of upper tiers, payment problem is still prevalent in the construction industry. The paper has reviewed some of the legislative, contractual and other administrative schemes for reducing payment risks; and their possible extension to deal with payment losses due to insolvency. Mostly legal provisions in security of payment Acts cater for losses due to deferred payments but not to insolvency payment losses. Some of the Acts have abolished contingent payment provisions, while some have counter clauses with similar objectives. For example the UK has contingent payment provision which is effective only when there is insolvency in the chain; Kansas city (US) clauses have no effect on the right of mechanic's lien. In any case, these provisions protect subcontractors from contractors but not the contractors from their clients.

In New Zealand, the CCA provisions take effect in the absence of contractual provisions. Further the CCA has no mechanism to tackle losses due to insolvency. In this sense, payment bond under special conditions of NZS 3910:2003 could be used as a better mechanism to secure payment losses to contractors. NZS 3910:2003 provides contractor suspension and termination rights in a contract as remedies for client's default of non-payment of scheduled amount; failure to submit payment bond; and becoming bankrupt or going into liquidation. Subsequently contractors could place the company in liquidation and claim their money. It is common for construction industry contractors and subcontractors to fall into unsecured creditor category whereby they receive nothing in the event of liquidation. Contractors' progress and final payments could be secured with payment/principal insolvency or advance bond while their retention can be secured by a retention bond. It is not impartial to retain payments from inception and hold it till the end of the defects liability period.

In the case of administrative solutions, this paper believes that bonds and guarantees; payment default or insolvency insurance; and registration and prequalification of upper tiers before undertaking any works; are viable measures though this may not be applicable to the New Zealand construction scene. Maintenance of separate escrow accounts or Buildsafe security of payment schemes are relatively new mechanisms with obvious merits that could be explored further.

Insolvency of upper tiers is due to factors outside of the contract and the industry itself. As a result insolvency prevention mechanisms would need to be considered when seeking viable solutions to payment problems. Future studies would need to make detailed assessments of these solutions in terms of costs and benefits. An assessment of their practicability and ease of use could generate the most feasible solution(s) to payment problems that are due to insolvency.

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