AUSTRALIAN GOVERNMENT SOLICITOR

Commercial Notes

Number 7 23 April 2003

Construction Guarantees – Safe as Houses?

Recourse to security under construction contracts

A principal under a construction contract takes comfort in the performance security given by the contractor. Frequently, this security is an unconditional bank bond or undertaking (often called a '*bank guarantee*'). The belief is that such security gives easy recourse to compensate the principal for an alleged breach of contract by the contractor.

This '*pulling*' of the guarantee, or the threat of doing so, is perceived to have the strategic advantage of giving the contractor an incentive to negotiate and to continue the work, as well as providing the principal with the financial assurance that it will not be out-of-pocket for a claim it has under the contract.

A recent case in the Supreme Court of Victoria [1] has, however, suggested that recourse to security provided by a contractor might not be as readily available to an aggrieved principal as believed. The case has reinforced the principle that the circumstances in which non-cash security may be converted, and recourse had to that money by a principal, depends very much on the terms of the contract.

[1] *Rejan Constructions Pty Ltd v Manningham Medical Centre Pty Ltd* [2002] VSC 579

This issue

Background

The proceedings involved a contract for the design and construction of a multi-level medical centre in Melbourne. The contract adopted the frequently used Standards Australia general conditions of contract in AS4300-1995.

The parties became embroiled in a dispute about the scope of the works under the contract. The principal asserted that the tenancy areas were part of the works. The contractor asserted that they were not.

Dispute notices were exchanged between the parties. The parties met but were unable to resolve the dispute. Ultimately, both parties purported to terminate the contract.

The principal then wrote to the contractor advising that it proposed to have recourse to the security given by the contractor in order to compensate it for the losses incurred in having to engage another contractor to complete the works.

The security took the form of two bank bonds, each for 2.5% of the contract price. The contractor sought an injunction restraining the principal from converting the bonds into cash.

The court granted the injunction to the contractor, preventing the principal from having recourse to the security.

Terms of the contract

Clause 5.6 of AS4300-1995 provides:

> A party may have recourse to security…and may convert into money security that does not consist of money where:
>
> (a) the party has become entitled to exercise a right under the contract in respect of the security…;
>
> (b) the party has given to the other party notice in writing, for the period stated in Annexure Part A or, if no period is stated, 5 days, of the party's intention to have recourse to the security…; and
>
> (c) the period stated in Annexure Part A or, if no period is stated, 5 days, has or have elapsed since the notice was given.

There was no dispute that the principal had complied with paragraphs (b) and (c). The issue was whether the termination of the contract and subsequent claim by the principal meant that the principal had '*become entitled to exercise a right under the contract in respect of the security*'.

The court found that only two provisions in AS4300-1995 gave rights in respect of the security.

First, clause 42.8 provided that the principal may deduct from moneys due to the contractor any money due from the contractor to the principal otherwise than under the contract. If those moneys were insufficient the principal could, subject to clause 5.6, have recourse to any retention moneys and, if those were insufficient, then to security under the contract. In other words, the principal could exercise a right of set off for moneys due to the principal by the contractor outside the contract by way of having recourse to the bank bonds.

Secondly, clause 42.9 provided that where, within the time provided by the contract, a party failed to pay the other party an amount due and payable under the contract, the other party may, subject to clause 5.6, have recourse to any retention moneys and, if those were insufficient, then to security under the contract.

The principal had essentially purported to terminate the contract on two bases: the first being that the contractor had committed a substantial breach of the contract by reason of, among other things, exhibiting an intention not to carry out the tenancy works and then failing to show cause why the principal should not terminate the contract.

The second basis was an alleged common law repudiation of the contract for much the same reasons. This repudiation was purportedly accepted by the principal.

Was the principal entitled to exercise rights in respect of the security?

The court considered whether either of these bases for termination meant that the principal had become *'entitled to exercise a right under the contract in respect of the security'*.

It was held that the termination on the basis of the contractor's alleged failure to show cause did not give the principal an '*immediate unqualified right in respect of the security*' as was contemplated by clause 5.6(a). In other words, there was no amount '*due and payable*' within the meaning of clause 42.9 which the contractor had failed to pay within the time provided for by the building contract.

The reason for this was that clause 42.9 did not provide any machinery for determining the amount of any sum due under the building contract to the principal. The contract intended the arbitration provisions in the dispute resolution clause to determine the sum if the parties could not agree. Unless and until this happened the amount claimed could not be said to be either '*due and payable*' or '*unpaid within the time provided by the contract*'.

The principal's alternative claim was that the contractor had repudiated the contract and that the principal had accepted that repudiation and terminated the contract at common law. Since the contract was at an end, so the argument goes, the entitlement of the principal could be said to arise '*otherwise than under the contract*' within the meaning of clause 42.8.

Again, the court refused to characterise the mere claim by the principal that the contractor owed the principal money to be money '*due and payable*'. In doing so the court went to some lengths to distinguish previous authority which had '*treated with great respect*' the right of a beneficiary/ principal to have recourse to security.

Reasons for refusing access to security

The Victorian Court of Appeal [2] had previously considered the operation of the security provisions in AS2124-1986 (an earlier version of AS4300-1995). It had there been found that the party claiming access to the security could have recourse to the security where, according to a bona fide claim made by the principal, moneys were due to it from the contractor which exceeded any moneys due from the principal to the contractor.

The court refused to follow this analysis, on the basis that these were two very different contracts under consideration and that the words '*entitlement*' in each document did not necessarily bear the same meaning.

In doing so the court noted that the 1992 and 1996 versions of the Australian Standard contract had introduced a procedure under which the principal must give notice before converting the security into money or having recourse to it. The intent of this was to give the contractor the right to seek interlocutory relief where the contractor disputes the principal's right to have recourse to the security. The court considered that this right would be 'illusory' if the principal's entitlement to exercise the right depended only upon making a bona fide claim for payment of money which was not specious or fanciful.

The court also considered that the right to have recourse to security in respect of unpaid moneys under the contract had to be read subject to clause 42.1 of the contract. That clause set out a comprehensive scheme for the assessment and certification of payment claims made by the contractor under the contract. Accordingly, money '*due and payable*' under the contract will ordinarily be subject to these certification procedures. In this way the contract itself provides an authoritative statement of liability, subject to review under the dispute resolution clause. In these circumstances, the principal could not use the right of set off under clause 42.9 to convert and have recourse to the bank bonds to satisfy its claim under the contract.

The court also considered that the use of the words '*has become entitled*' in the 1992 and 1996 versions indicated that some determination of entitlement is required, whether by certificate, agreement, arbitral award or otherwise. A mere claim is not enough.

Implications for clients

The case is salutary in reinforcing the dangers of too readily concluding that the rights conferred by performance guarantees '*should depend upon the mere assertion by a disputing party of a right to payment of a sum of money*'.

The name and nature of unconditional undertakings suggest a form of security readily accessible in a broad range of circumstances. However, whether recourse may be had to this security depends on the terms of the contract. If, as is the case with the 1992 and 1996 Australian Standards, the circumstances in which recourse may be had are circumscribed, the courts will give effect to that limitation by granting an injunction to prevent a principal from converting

[2] *Bachmann Pty Ltd v BHP Power New Zealand Ltd* [1999] 1 VR 420

non-cash security and having recourse to the money unless the relevant '*entitlement*' exists.

In determining the entitlement, the court will look to the intention of the parties in construing the circumstances in which recourse may be had to security. It will look to see whether the parties intended the security to support a valid claim for damages or whether it was intended the security deal with the risk of a party being out-of-pocket pending resolution or determination of a dispute.

In drafting construction contracts the parties must be clear both about the real purpose of requiring the security and the circumstances in which recourse may be had to it. If it is intended that a party should be able to enforce an unconditional undertaking on the basis of a mere claim then the contract should make this abundantly clear.

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Is Probity Advice Privileged?

Lawyers are often engaged to act as probity adviser for clients who are conducting a tender process. Usually in these circumstances there is also a legal firm acting as the legal adviser to the client. The probity adviser is typically tasked to establish a probity regime; monitor procedural aspects of the tender process; advise the client in relation to process and probity issues; and report on compliance with probity requirements. If the probity of a tender process is subsequently challenged and the matter proceeds to litigation, then the question of whether this work is protected by legal professional privilege may become very important.

The nature of the privilege

Legal professional privilege applies to confidential communications between a client and the client's legal adviser for the dominant purpose of giving or receiving legal advice or for use in anticipated litigation: *Esso Australia Resources Limited v Federal Commissioner of Taxation* (1999) 201 CLR 49.

In addition, some jurisdictions provide for the privilege by statute, notably the federal jurisdiction and in New South Wales. Section 118 of the *Evidence Act 1995* (Cth) provides for the privilege, calling it 'client legal privilege'. Section 118 applies only where privileged documents are sought to be 'adduced' in evidence. The section does not apply at other times (e.g., during the discovery process) although the common law privilege does apply then.

To attract the privilege, the purpose must fall within the privilege when the document was created: Barwick CJ in *Grant v Downs* (1976) 135 CLR 674 at 678.

Documents created for the dual purpose of internal management and legal advice are not privileged if the purposes are of equal weight – a test 'intended to bring within the scope of client legal privilege a document brought into existence for the purpose of legal advice notwithstanding that some *ancillary* use of the document was contemplated at that time': *Sparnon v Apand Pty Ltd* (1996) 68 FCR 322 at 328 per Branson J.

Privilege only applies to a lawyer with appropriate qualifications and independence. This raises particular issues for in-house advisers.

For a more detailed account of legal professional privilege and its implications for the Commonwealth context see *Legal Briefing* Issue 65 (2 October 2002).

Application of the privilege to probity work

To date there is little case law dealing specifically with the application of the privilege to probity work.

In *Nederlandse Reassurantie Groep Holding NV v Bacon & Woodrow (a firm) and others* [1995] 1 All

ER 976, Coleman J considered whether commercial advice given by lawyers in the course of a transaction was privileged.

The facts were as follows. In 1990 the plaintiff, a Dutch company, entered into negotiations to purchase the share capital of three insurance companies. The plaintiff assembled a team of advisers comprising actuaries, accountants, banking and corporate advisers, and lawyers. During the period leading up to the purchase there were numerous written and oral communications between the plaintiff and its advisers and also between advisers. The shares were purchased and the plaintiff discovered that the company was exposed to huge claims due to the inadequacy of its insurance cover. The plaintiff sued its non-legal advisers claiming it had not been properly advised. The defendants sought discovery of documents provided by the legal advisers to the plaintiff on the basis that these documents related to the general commercial advisability of making the purchase.

Coleman J held that if a solicitor is instructed for the purpose of providing legal advice in relation to a particular transaction, then all communications between solicitor and client relating to the transaction will be privileged, notwithstanding that they do not contain legal advice, provided they are directly related to the performance by the solicitor of their professional duty as legal adviser to the client (*Nederlandse Reassurantie* at page 982). A solicitor's professional duty is frequently not exclusively related to providing legal advice, it may relate to the commercial wisdom of entering into a given transaction in relation to which legal advice is sought (*Nederlandse Reassurantie* at page 983).

In *National Tertiary Education Industry Union v Commonwealth and D A Kemp* [2002] FCA 441, Weinberg J considered the application of the privilege to documents created during a probity exercise. The applicant, the National Tertiary Education Industry Union, sought the imposition of penalties under section 170NF of the *Workplace Relations Act 1996* on the basis that the respondents had allegedly coerced certain tertiary institutions engaged in negotiating certified agreements by making the approval of funding contingent on the institutions adopting a certain stance in the negotiations. The Court found that the respondents' conduct could not amount to coercion for the purposes of the relevant legislation.

In the course of interlocutory proceedings Weinberg J made rulings on 19 April 2001 regarding whether client legal privilege attached to probity advice. (Written reasons for the rulings were not handed down by the Court and do not appear in the report of the case. However, the basis of the rulings can be discerned from the transcript of the proceedings.) A law firm had been retained as the probity adviser to the Commonwealth in connection with the processing of applications for funds by institutions. As from 5 January 2000 the law firm was retained to 'scrutinise the assessments carried out by the Commonwealth, to ensure fairness in the assessments and consistency in the approach to assessment of applications'.

The respondents submitted that all of the probity advice was protected by privilege. However, the Judge held that much of the advice was not. This included documents relating to the appointment of the law firm as probity adviser, advice relating to the guidelines and process generally and documents to and from the probity adviser about particular applications. However, the Judge did find that documents after 1 May 2000 were privileged. The reason was that from that date onwards the evidence showed that applications for grants were submitted to the law firm for 'legal advice as to consistency and defensibility'.

At page 29 of the transcript Weinberg J said that 'you cannot achieve protection for documents by asking solicitors to perform a task which equally well could have been performed by other consultants or other experts...Does the evidence before me – because that is what it comes back to – establish what the Commonwealth was seeking…can properly be characterised as legal advice…?'.

Loss of the privilege

Loss of the common law privilege has recently been considered by the Victorian Court of Appeal in *British American Tobacco Australia Services Ltd v McCabe* [2002] VSCA 197. Mrs McCabe had made an application to strike out the defence. In the course of this application a dispute arose as to legal advices that had been provided by separate firms of solicitors to the defendant. The defendant had filed an affidavit sworn by an in-house lawyer in opposition to the application. Annexed to the affidavit were letters of advice from one law firm in 1992 and another law firm in 1998 as to the legal obligations of the defendant with respect to the retention and destruction of documents. The trial judge, Eames J found that the affidavit had been tendered to establish that the defendant had a longstanding document retention policy and that it had acted on legal advice as to the propriety of past actions. The plaintiff submitted that 'ordinary notions of fairness' dictate that his client should have access to the balance of advices on these topics. The Court held there had been a waiver of the privilege in respect of *all* legal advices for the period 1990 to 1998 related to the reasons for the tender of the two advices disclosed in the affidavit.

This finding was reversed on appeal. The Court of Appeal found that there had not been a waiver and held that where there has been waiver in relation to one piece (or part) of advice '…the privilege is impliedly waived in relation to another (advice) if – and only if – that other is necessary to a proper understanding of the first…'. In this case the Court of Appeal considered that the advices in question were complete in themselves and could be understood without reference to other documents: *McCabe* at paragraph 121.

Section 122 of the *Evidence Act 1995* (Cth) deals with loss of the statutory privilege. In particular subsections 122 (1) and (2) provide that the privilege is lost where the client has 'knowingly and voluntarily' 'disclosed' to another person the 'substance' of the evidence. The test is a 'quantitative one', and the Court asks whether there has been a sufficient disclosure to warrant loss of privilege. The mere reference to the existence of legal advice will not amount to a disclosure. A statement to shareholders (made in the context of an advice to them to reject an offer by a third party to purchase their shares) concerning existing litigation about the ratio for convertible notes to ordinary shares that: 'the company maintains the correct ratio is 1:1 and has legal advice supporting this proposition' has been held to disclose the 'substance' of the legal advice: *Ampolex Ltd v Perpetual Trustee Company (Canberra) Ltd* (1996) 40 NSW LR 12 at 15.

In *SVI Systems Pty Ltd v Best & Less Pty Ltd* [2000] FCA 1507 Einfeld J again considered loss of the statutory privilege in a case where legal advice had been merely mentioned. One of the parties had received legal advice not to proceed with the roll-out of its retail stores. It disclosed that it had determined not to proceed on the basis of legal advice from its solicitors. Einfeld J said that the case was to be decided on the basis of the contract and that the legal advice was not of relevance in this regard. He held that even though the party disclosed the 'bottom line' of the advice, this did not amount to a disclosure of the substance. He noted that it would be a significant extension of the law if advice had to be disclosed merely because a party mentioned that it had received legal advice and acted on that advice.

Conclusion

Legal professional privilege is likely to apply to general commercial advice where lawyers are engaged to provide legal advice, and general commercial advice is also provided as part of the provision of the legal advice. For example, if a legal firm is acting in a sale transaction and provides advice about the commercial wisdom of aspects of the transaction as part of the legal advice, that advice is likely to be privileged.

Similarly, probity advice should be privileged if it is directly related to legal advice.

The privilege may be lost in a variety of circumstances. The common law provides for waiver of the privilege and the test is whether it would be 'fair' to require that an otherwise privileged communication be disclosed. Certainly, where part of a legal advice has been selectively disclosed it may be fair to require that the balance be disclosed.

Where the *Evidence Act 1995* (Cth) applies, namely where the evidence is being adduced in a federal or territory court, section 122 provides that the privilege is lost where a party has 'knowingly and voluntarily disclosed' to another person the 'substance' of the advice. Just what amounts to disclosure of the 'substance' of an advice is a question of degree. To merely state one has obtained legal advice and acted on it, is not a disclosure, but to disclose conclusions of an advice is more likely to be.

Implications for clients

When lawyers are retained, the wording of the retainer is important – clients should ensure that work has been appropriately described. For example, the words 'to provide legal services to ensure defensibility and consistency' is more likely to attract legal professional privilege than if lawyers were engaged to advise as to 'fairness and probity'.

Where the conclusions of the probity adviser are to be communicated to a third party, clients should consider whether the privilege may be lost. This is particularly so where the report of a probity adviser is put forward to indicate that the process has been fair or appropriate. It would be prudent to obtain legal advice before making a disclosure.

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Defamation on the Web

Dow Jones & Company Inc v Gutnick
(2002) 194 ALR 433

The High Court's recent decision in *Gutnick* has excited considerable media interest and comment as it is believed to be the first time a nation's highest court has ruled on the issue of where defamation occurs when it arises out of a publication on the Internet.

Background

Mr Joseph Gutnick is a Melbourne businessman. Dow Jones is a US corporation which publishes the *Wall Street Journal* newspaper and *Barron's* magazine. Dow Jones also operates a web-based subscription news site known as WSJ.com which includes an online version of *Barron's* magazine – *Barron's Online*.

The 28 October 2000 edition of *Barron's Online* contained an article entitled 'Unholy Gains', containing several references to Mr Gutnick, among other things associating him with a convicted tax evader, and another person awaiting trial for alleged stock manipulation in New York.

Mr Gutnick contended that part of the article defamed him and brought an action in the Supreme Court of Victoria claiming damages for defamation.

Dow Jones contended that the proceedings in the Supreme Court should be stayed on the grounds that that Court was an inappropriate forum, as the alleged defamation was published in New Jersey – not Victoria. Hedigan J of the Supreme Court rejected this contention. Dow Jones was subsequently refused leave to appeal to the Court of Appeal of Victoria, but granted special leave to appeal to the High Court.

Issue

The issue was characterised starkly by Callinan J, whose judgment (see p. 475) begins:

> ‘The question which this case raises is whether the development of the Internet calls for a radical shift in the law of defamation’.

The majority described the principal question for determination to be ‘where was the material complained of published?’

The issues raised by this question were summarised by Kirby J (at p. 450) as:

- the jurisdiction of the Australian court to decide the action
- if jurisdiction does exist, what law to apply, and
- whether the proceedings should be stayed on the grounds that an Australian court is nonetheless an inconvenient forum.

The presentation of these issues for the Court’s determination was driven, as Kirby J pointed out, by some important practical considerations. The law of defamation in Victoria is more favourable to plaintiffs, given that defamation laws in the United States were greatly influenced by the First Amendment and freedom of speech. It seems that the contest between the parties was animated less by concerns over jurisdictional sovereignty or the logistical challenges of an inconvenient forum, and more by the simple truth that the action is quite likely to succeed in Victoria but would almost certainly fail in New Jersey.

Arguments

The respondent, Mr Gutnick, argued that it was well established law in Australia that for the purposes of the tort of defamation, publication takes place where the allegedly defamatory material is comprehended by its readers. It was also emphasised that the article in question was disseminated via a subscription service, and that those people in Victoria who read the article were Dow Jones subscribers. The effect of this is that Dow Jones must have intended the article for consumption in Victoria. It was also argued that the appellant sought to impose upon Australian residents for the purposes of this and many other cases, an American legal hegemony in relation to Internet publications.

The appellant, Dow Jones, claimed that the article was published in New Jersey at the time the article was uploaded to the web servers they operate in New Jersey. Dow Jones advanced two distinct arguments in support of this assertion – one technical and the other rooted in policy.

Dow Jones’ technical argument for New Jersey as the place of publication relied on an alleged distinction between traditional print and broadcast ‘publication’, and web-based ‘publication”. According to Dow Jones, traditional publishing involved the publisher in a very active way in the directing of their publications to a particular place or places and allows the publisher a measure of effective control. However, the Internet was said to be very different in that the publisher is restricted to the more passive role of simply loading information onto a web server. There was no effective control over who then accesses the information or where they choose to do so. The information was not actively sent anywhere by the publisher. It was the would-be reader who must actively seek information by downloading it to their web browser.

This argument did not succeed. It seems likely that the subscription nature of the publication was material to the High Court’s decision on this point.

Dow Jones’ policy argument was that unless the place of publication is fixed as the place of uploading to the web server(s), publishers will be forced to take account of the law of every country on earth as the publisher cannot control the location of the web browsers of would-be readers. This places publishers in an unacceptable position of global liability risk.

High Court’s decision

The High Court decided unanimously in Mr Gutnick’s favour, dismissing Dow Jones’ appeal.

Gleeson CJ, McHugh, Gummow and Hayne JJ

In a joint judgment, these justices held that publication is a bilateral act in which a publisher makes information available and a third party has that information available for their comprehension. The bilateral nature of publication makes it misleading to focus on the publisher's location. Further, it is an established principle of defamation law that (to quote Dixon J in *Lee v Wilson & Mackinnon* (1934) 51 CLR 276, at 287):

> 'It is the publication, not the composition of a libel, which is the actionable wrong.' (p. 440)

Defamation is to be located at the place where damage to reputation occurs.

On the issue of potential 'global risk' for Internet publishers, it was said that practical considerations such as the requirement for claimants to have a reputation in the place where they are defamed, and the reality that a favourable judgment is only of value if it will be enforced in a jurisdiction where the defendant has assets, will limit the scale of this perceived problem (p. 447). It was further said that:

> 'identifying the person about whom material is to be published will readily identify the relevant defamation law to which that person may resort' (p. 447).

Gaudron J

Gaudron J agreed with the decision of the majority and with their reasons, but made some additional points about the American 'single publication' rule. She argued that Australian jurisprudence can similarly empower a court to determine the whole of a legal controversy, further undermining the appellant's contention that allowing an Australian court to take jurisdiction created a danger of multiple suits in different jurisdictions.

Kirby J

Kirby J agreed that the Internet is a unique technology and that such a novel technological development may likewise require a new legal paradigm. However, he stated that to ignore existing law and precedent would exceed judicial authority. He described the outcome in *Gutnick* as 'contrary to intuition' and called for national legislative attention and international discussion and agreement.

Callinan J

Callinan J explicitly rejected both the notion that the Internet is a revolutionary phenomena, non-analogous to any previous technology, and the appellant's argument that a web server is essentially passive. His Honour affirmed the long line of authority holding that the torts of libel and slander are committed when and where comprehension of the defamatory matter occurs, regardless of the medium of publication. He also expressed his support for the contention that the appellant was attempting to impose an 'American legal hegemony' on Australians (see p. 483).

Implications for clients

Gutnick is of obvious importance to clients engaged in Internet publication. Legal liability for allegedly defamatory publications clearly differs according to jurisdiction and choice of law. If jurisdiction is established by a reader downloading content, then Internet publishers will need to be mindful of the potential for defamation in multiple jurisdictions.

The High Court's decision has already attracted some criticism. [1] The main criticism is that the decision will inhibit Internet development and freedom of speech as it exposes Internet publishers to global risk of legal action, often in jurisdictions where legal and social norms are very different. It may be equally valid to argue that claimants are entitled to claim where the damage to their reputation actually occurs, according to their own laws and social norms. This perspective, obviously, will not appeal to the media.

The extent to which the courts in other countries will follow *Gutnick* is unclear. The issue of jurisdiction and defamation through Internet publication was recently canvassed in a UK Law Commission report

Defamation and the Internet: A Preliminary Investigation. The Law Commission concluded the issue to be extremely challenging and suggested that 'any solution would require an international treaty, accompanied by greater harmonisation of the substantive law of defamation'.

Less than a week after the High Court handed down its decision in *Gutnick*, the US 4th Circuit Court of Appeals in a similar case affirmed its view that the placing of information on the Internet is not, in itself, enough to subject the publisher to the jurisdiction of the state where the information is downloaded. Something more than posting and accessibility is needed in order to demonstrate that the publisher purposefully targeted the forum state in a substantial way. [2]

The full text of the High Court's decision is available online at http://www.austlii.edu.au/au/cases/cth/high_ct/2002/56.html.

Notes

1 See, for example, the editorial, 'A Dark Day for the Internet', *The Australian*, 11 December 2002, p. 14.

2 *Young v New Haven Advocate*, available online at http:laws.lp.findlaw.com/4th/012340p.html

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Private Financing in the Commonwealth

The Commonwealth has yet to undertake a major procurement using private financing (PF). [1]

The proposed joint operational Headquarters Australian Theatre (HQAST) for the Department of Defence, to be constructed south of Bungendore in New South Wales, is being examined as a possible PF procurement. The Government is expected to decide later in the year whether to proceed by way of PF or by using a more traditional procurement methodology.

The Australian Customs Service is also investigating the use of PF for its Coastwatch Project.

During the assessment of the procurement method for the Navy's patrol boats project it became apparent that there are perceived accounting standard and taxation barriers to the greater use of PF in Commonwealth procurement.

Current barriers

There is currently no Australian Accounting Standard (AAS) which specifically deals with the accounting treatment of PF. This gives rise to doubt as to whether PF schemes should appear in the Government's '*balance sheet*' or not. In the UK the Treasury has issued guidelines (FRS5) to account for PF transactions which allow most PF transactions to be excluded from Government borrowing figures on the grounds that they involve sufficient risk transfer to warrant the project being declared as 'off balance sheet'.

In Australia, since there is no specific AAS to deal with risk allocation issues associated with PF, AAS17 (which deals with leases) is relied on to categorise PF arrangements. This standard has not been designed to deal with PF risk allocations and can lead to PF leases being characterised as finance

leases (which should be recognised on the lessee's balance sheet) rather than operating leases (under which payments by the lessee are an expense in the lessee's financial statements), despite significant project risks being transferred to the private sector contractor.

Classification of leases as finance leases is a disincentive to both the private sector and government to use PF arrangements. The Australian Accounting Standards Board (AASB) with representatives from Treasury has established a working group to determine how these PF projects should be treated in Government accounts. The Heads of Treasury forum has recently recommended to the AASB that a standard, similar to the UK's FRS5, be adopted for PF and similar arrangements in Australia.

The so-called '*leasing provisions*' of the *Income Tax Assessment Act 1936* (Section 51AD and Division 16D) are also seen as disincentives to PF procurement. The effect of these sections is to deny tax deductability for certain payments by the private sector PF participant because of the involvement of the tax-exempt public sector, while at the same time making income associated with the property taxable.

It is understood that the Government is proposing to abolish section 51AD and amend Division 16D. If this happens it will remove some of these perceived barriers to the use of PF project structures, at least from the private sector's viewpoint. However, it will have little impact at the Commonwealth level, as a whole-of-government approach to 'value for money' is taken, which incorporates into the PF model the cost of any tax leakage arising as a result of passing tax benefits from a tax exempt body to the private sector.

From the Government's viewpoint, the key question remains whether project delivery by PF represents value for money. The Department of Finance has indicated that it considers that PF procurement can deliver value for money, even if the lease is classified as an on-balance-sheet finance lease, if sufficient, cost-effective risk transfer is achieved. [2]

Recent UK experience

The UK National Audit Office has recently released a report on the construction performance under PF delivery. [3] The report examined 3 key areas of construction under all English PF projects let by the central government:

- price certainty
- timing of delivery
- quality of design and construction

The report showed that about 80% of projects had not experienced any construction related price increase after the award of contracts. Where there had been a price increase it was due to variations sought by the procuring department rather than the construction contractor. Historically, over 70% of public sector construction projects had run over budget. In those PF projects where there were cost overruns the price increases were generally relatively small.

It also found that 28 of the 37 projects surveyed had been delivered on time or earlier than specified in the contract. Of those projects which were not delivered on time, two-thirds were delayed by two months or less. Where projects have been delivered late, departments have been able to defer payments under the contract, make payment deductions or seek damages.

Finally, most public sector project managers surveyed were satisfied with the design, construction and performance of their buildings.

The report concluded that there was strong evidence that the PF approach brings significant benefits to government in terms of delivering built assets on-time and for the price expected by the public sector.

The Department of Defence has traditionally experienced difficulties in optimising value for

money in these areas of its construction projects.[4] Typically, the obstacles have included inaccurate cost estimates because of scoping errors and stakeholder variations after contract, as well as difficulties reaching appropriate risk allocation and management strategies.

Identifying the costs of and funding through-life operating costs of Defence infrastructure assets has also been an issue. It would be reasonable to infer that other Commonwealth departments and agencies face similar issues in their construction procurement.

Based on recent UK experience there would seem to be opportunities for PF procurement methods at the Commonwealth level provided the right project is selected. However, if PF is to have a future as a legitimate procurement method for the Commonwealth, it needs a value for money success story upon which to build momentum. Whether the Government believes HQAST can be that story will be known later this year.

Notes

1 Webb, R and Pulle, B, *Public Private Partnerships: An Introduction*, Economics, Commerce and Industrial Relations Group, Department of the Parliamentary Library, Research Paper No. 1, 2002–03

2 Lisa Rauter, Director, Private Financing Unit, Department of Finance and Administration, Panel Debate, *Defence Summit 2003*, 25 February 2003

3 *PFI: Construction Performance*, Report by the Comptroller and Auditor General, National Audit Office HC 371 Session 2002–2003, 5 February 2003

4 Mike Scrafton, Head of Infrastructure Division, Corporate Services and Infrastructure Group, Department of Defence, Speech given to *Defence Summit 2003*, 25 February 2003

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ISSN 1443-9549