

## Rights in construction contracts can constitute a security interest

### Construction Update

#### Introduction

A recent New Zealand High Court decision *McCloy v Manukau Institute of Technology* [2013] NZHC 936 held that a step-in right in a construction contract is a security interest under the New Zealand equivalent of the *Personal Property Securities Act 2009* (Cth) (PPSA).

Construction contracts often contain a right for the developer to ‘step-in’ and use any of the builder’s tools, equipment and other personal property which may still remain on the building site after the builder has defaulted under the contract. This right enables the developer to take control of that personal property in order to complete the development.

In many cases, this right goes beyond being a mere right to use the personal property for a specific purpose and further entitles the developer to sell that personal property in order to repay any money owing to it. In the *McCloy* case, the Court held that this broad step-in right was a security interest.

The New Zealand decision is likely to be followed in Australia as the definition of “security interest” in the PPSA closely mirrors the wording in the New Zealand legislation.

The PPSA provides that the holder of a security interest must ‘perfect’ its security interest or else it could lose its rights to another security holder which did perfect its security interest in the same personal property. The most common method of ‘perfection’ is registration on the Personal Property Securities Register (PPSR).

#### What does this mean?

Simply put, all developers who enter into construction contracts containing this

#### Who does this affect?

- Developers
- Builders

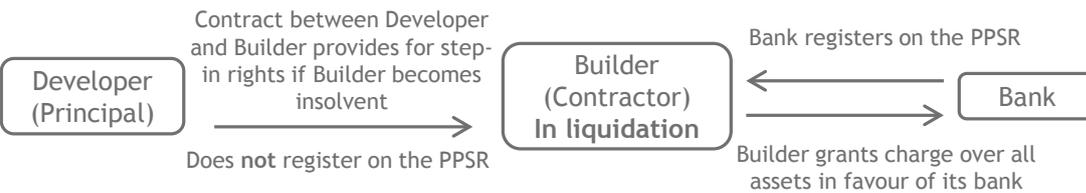
#### Article Highlights

- The recent New Zealand High Court decision in the *McCloy* case, held that a step-in right in a construction contract is a security interest and it is likely to be followed in Australia as the definition of “security interest” in the PPSA closely mirrors the wording in the New Zealand legislation.
- All developers who enter into construction contracts containing this broad step-in right should register their security interest on the PPSR or risk losing their rights to sell that property to recover debts in a priority dispute.

broad step-in right should register their security interest on the PPSR or risk losing their rights to sell that property to recover debts in a priority dispute.

Notably, provisions of the Australian Standards construction contracts (for example the default clause 39 in AS4000-1997 General Conditions of Contract and AS4902-2000 General Conditions of Contract for Design and Construct) contain this broad step-in right. As a result, developers who enter into these standard construction contracts will have a registrable security interest for the purposes of the PPSA and must register that security interest to avoid losing priority to other secured creditors with a registered security interest in the same personal property.

Take the following example. A builder has obtained finance from a bank and has given that bank a charge over all of its personal property. If the bank registers its security interest and the developer does not, the bank's security interest will take priority and (in a default scenario) the bank will be entitled to sell any of the builder's personal property that has been left on site. If both the bank and the developer have competing registered security interests, the first to register wins in a priority contest.



It is irrelevant that the builder's property cannot be ascertained at the point in time that the construction contract has been entered into. It is also irrelevant that all parties do not expect the trigger for exercising the step-in right (builder default) to occur. A security interest can be an interest in future property, therefore a step-in right can be registered on the PPSR before any monies are actually owing by the builder to the developer. Developers should register their security interests as soon as the relevant contract is entered into.

The developer in the *McCloy* case failed to register its security interest created by the step-in right. Had it done so before the builder's bank had registered its security interest, it would have had priority over the builder's bank and could have exercised its power to sell any personal property that the builder had left on site. Instead, the builder's bank took priority and the developer lost its rights as a secured creditor.

### What about existing construction contracts?

In reviewing existing construction contracts, the first step for the developer is determining whether or not the relevant construction contract is dated earlier than 30 January 2012. If it is, the developer will have "temporary perfection"

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status until 30 January 2014. The developer may register at any point up to 29 January 2014 and its security interest will be deemed to be registered as at 30 January 2012. However, as this temporary perfection status expires early next year, we recommend registering now, to avoid missing the deadline.

If the existing construction contract is dated after 30 January 2012, the developer should already have registered in order to obtain the best possible protection under the PPSA. If it hasn't yet registered, this is not fatal (there is no requirement to register within a specific time) however we recommend registering as soon as possible. The sooner one registers, the sooner one establishes its priority position over any subsequent registrations.

*Disclaimer: This publication is intended to provide general information only and should not be relied upon as legal advice. If you require legal advice on a matter please contact us.*

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