Sham Contracting
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There is a notorious practice in the construction industry known as ‘sham contracting’. It works as follows. A contractor has several registered companies. For the present purposes, they will be given the fictional names of A1, A2 and A3. The companies trade under the umbrella of the ‘A Group’ (another fictional name that is probably not a registered business name or, if it is registered, it is the business name under which all of A1, A2 and A3 trade). Only A1 has any assets. A1 tenders for a large project, let us say, to a government department. The department’s financial check on A1 proves satisfactory and A1 wins the contract.

Using the letterhead ‘A Group’ the contractor invites tenders from subcontractors. There is nothing on the letterhead to indicate which of the companies in the A Group intends to accept the subcontractors’ tenders. Believing that they are tendering to the company that won the government contract, the subcontractors address tenders to the A Group. They are notified by the A Group that their tenders are accepted. Then, often after they have commenced work, they are sent a contract in the name of A2 to sign. Usually the subcontractors don’t appreciate the fraud that the contractor intends to perpetrate and they sign up with A2.

The subcontractors send invoices for progress payments to A2. A2 has no money so A1 pays the invoices. When it comes to the final payment, the subcontractors find that they are owed money but A2 is insolvent. A2 may even have changed its name to protect the reputation of A1. If a subcontractor makes a claim against A1, A1 will defend the claim by arguing that A1 had no contract with the subcontractor. A1 will say that A2 was a subcontractor to A1 and A1 owes no money to A2. A1 will have a sham subcontract with A2 and A1 will say that moneys paid by A1 were only paid to the subcontractor at the direction of A2. A1 will give the government department statutory declarations that A1 has paid all its subcontractors.

Usually, the directors of A1 will be directors of A2 and A2 will have no separate office, management or employees. There may be correspondence and directions on the letterhead of A2 to subcontractors but the correspondence and directions will actually emanate from the management and staff A1. Although subcontractors will be told to invoice A2, A2 may not even have a bank account. It is most unlikely that moneys will flow from A1 to A2. To use the words of Buchanan J cited below, A2 ‘has no assets and no management structure of its own; and it exists only as a corporate shell to protect another company, which does have assets, from liability’.

In industrial law, a sham contract is where an employer deliberately disguises an employment relationship as an independent contracting arrangement to avoid giving employees their full entitlements. Under the Fair Work Act 2009 (Cth) employees can enforce entitlements against the employer notwithstanding the existence of a sham contract.

In Fair Work Ombudsman v Ramsey Food Processing Pty Ltd [2011] FCA 1176 Ramsey who operated an abattoir established a subsidiary called Tempus Holdings Pty Ltd who employed 11 workers. Ramsey entered a contract with Tempus under which Tempus agreed to provide labour to Ramsay. The only money that went into the account of Tempus was what was necessary to pay the employees. Tempus went into
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liquidation with no assets and owing money to the employees. The employees were successful in recovering their unpaid entitlements from Ramsey. At [76] to [78] Buchanan J said:

There may be many reasons why companies, businesses or enterprises associated with each other might wish to organise their affairs in a way where one legal personality employs labour for the ultimate use and benefit of other legal personalities. Such arrangements will often not be characterised or accompanied by the apparent profitability or identified reward which might be necessary in order to regard an arms-length arrangement as a genuine one.

In such intra-group arrangements there may be overlapping, or even common, directorships, interlocking shareholdings (either cross-ownership or through ultimate ownership) and there is frequently a system of cross-guarantees in place. Little of this may be apparent to outsiders. The details may not be discoverable through the public records system. Arrangements between or amongst companies related in this way where one company (or more) operates to engage labour while others are concerned with management, operations, marketing or sales are by no means unusual. They are certainly not illegal. Arrangements along these lines may even be indispensable for some forms of business activity e.g. joint ventures. Although more than mere lip service must be paid to the separation of legal personality provided by individual incorporation, the tests applied to other labour hire arrangements, of independence and separate business, are either not relevant or are much less readily applied in such a circumstance.

Nevertheless, it must be possible to identify a rational explanation for the arrangement and the explanation must be satisfactorily related to an intelligible business objective. That is so because otherwise, doctrines of agency, at least, may operate to defeat a bare claim of independence and isolated liability, supported only by a bare reference to separate incorporation. That is particularly likely to be the case when: the separate employing company is completely reliant upon a company to which it purportedly supplies labour; it has no assets and no management structure of its own; and it exists only as a corporate shell to protect another company, which does have assets, from liability to employees. In such a case a court might not hesitate long before pronouncing the arrangement ineffective or, in a more serious case, a sham.

In litigation there are avenues for discovering the internal workings of the companies and there can be remedies for deceptive conduct. The directors can be cross-examined and the dealings between the companies in the A Group can be exposed. In adjudication, the remedies open to the subcontractors and the capacity of subcontractors to expose the sham are much more limited. However, there is one important possibility. That is that the subcontractors can show that, irrespective of the fact that they signed a subcontract with A2, they had an ‘arrangement’ with A1 that is a ‘construction contract’ within the meaning of the term in a security of payment Act. For example, in s 4 of the Building and Construction Industry Security of Payment Act 1999 (NSW), a ‘construction contract’ is defined to mean ‘a contract or other arrangement under which one party undertakes to carry out construction work, or to supply related goods and services, for another party’.

In an adjudication by a subcontractor against A1, A1 will argue that the subcontract was with A2. The claimant may be able to satisfy the adjudicator that the subcontract with A2 was a sham and, in fact, the work was carried out for A1 and A1 had an arrangement with the subcontractor for payment. This is a jurisdictional issue. An adjudicator cannot decide the issue but, before proceeding to adjudicate, the
adjudicator must be satisfied that he or she appears to have jurisdiction. Until the jurisdictional issue is decided by a court, it seems that an adjudicator should be careful not to deny the claimant the opportunity to have the claim adjudicated. The respondent can challenge jurisdiction in the Supreme Court but in those proceedings the possibility exists of making discovery, cross examining the directors of A1 and raising other issues, even possible remedies under the *Competition and Consumer Act 2010* (Cth).

In NSW, on commencing an adjudication, the subcontractor will probably give the principal (the government department) a payment withholding request under s 26A of the *Building and Construction Industry Security of Payment Act 1999* (NSW). The principal will not know whether the adjudication application is valid. Since the adjudicator cannot determine that issue, an opinion by the adjudicator that the application is invalid is of no effect. Only the Supreme Court can declare the adjudication application invalid. The consequence is that until there is a decision of the Supreme Court, the principal cannot (without the consent of both parties) safely release the moneys withheld by the principal.

There does not appear to be any reported case where a court has considered a sham contract in the context of adjudication. But the judgment of the NSW Court of Appeal in *Edelbrand Pty Ltd v HM Australia Holdings Pty Ltd* [2012] NSWCA 31 suggests that the literal and technical interpretation that many Supreme Court judges have been giving the *Building and Construction Industry Security of Payment Act 1999* (NSW) may have to come to an end. The literal and technical interpretation has favoured many respondents and encouraged many challenges to adjudicators’ decisions. McColl JA and Tobias AJA agreed with the reasons of Bathurst CJ for setting aside the orders of Einstein J and finding that the adjudicator had jurisdiction. At [30] Bathurst CJ said:

> In the present case, the legislation in question is remedial legislation. In these circumstances the words in the definition of related goods and services in s 6 of the Act should be given a liberal interpretation, within the confines of the actual language employed and what is fairly open on the words used: *Khoury v Government Insurance Office (NSW)* (1984) 165 CLR 622 at 638. In *IW v The City of Perth* [1997] HCA 30; (1997) 191 CLR 1 at 12, Brennan CJ and McHugh J put the position in the following terms (citations omitted):
> “… beneficial and remedial legislation, like the Act, is to be given a liberal construction. It is to be given ‘a fair, large at liberal’ interpretation rather than one which is ‘literal or technical’. Nevertheless, the task remains one of statutory construction. Although a provision of the Act must be given a liberal and beneficial construction a court or tribunal is not at liberty to give it a construction that is unreasonable or unnatural.”

The approach of the Court of Appeal in *Edelbrand* suggests that the broad definition of a construction contract may enable subcontractors to overcome sham contracts.