



Final Report

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Independent

Inquiry into Construction Industry Insolvency in NSW

November 2012





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INTRODUCTION

Mr Brian Ernst a solicitor practising in the field, told the Construction Industry Conference at Parliament House, Canberra on 31 May 1991 that:

“One can always have sympathy with the proposition that he who does the work should get paid for it.”¹

The question is not whether one has sympathy for the statement, indeed it is impossible to gainsay the proposition. More than sympathy is needed. One of the important questions for the Inquiry concerns the situation where the head contractor has been paid for the subcontractor’s work, has not passed on payment to the subcontractor and then becomes insolvent. Other related questions raise challenging issues concerning other practices which work against the efforts of subcontractors to be paid fairly for work they have done.

A contrasting view

One submission to the Inquiry suggested that, insolvency may be considered:

“...a therapeutic and necessary cleansing of bad risk in the market.”²

A harsh summation no doubt, of what might be considered the almost inevitable outcome of poor decision making by some in the building and construction industry. From its commencement, this Inquiry has made it clear that there can be no remedy applied through government action or reform, to the problems which arise from incompetence, inexperience or neglect by head contractors and subcontractors in the industry.

However there is a great deal that can be done to prevent and reduce insolvencies at *both* levels in the sector as well as reducing the *effects* of insolvency in the industry overall.

The work of the Inquiry

The Inquiry has set about the tasks assigned to it by Government through the Terms of Reference, with a firm commitment to ensure that all parts of the industry have had ample opportunity to place their views on the record and debate them with the Inquiry. The section of the Report entitled ‘The Conduct of the Inquiry’ sets out the methods used to ensure that the spectrum of views and experiences in the business, employee and community sectors were considered and tested.

¹ Queensland Government *Security of Payment for subcontractors in the building and construction industry Discussion Paper*, November 1991 (“1991 Queensland Discussion Paper”), p. 5, para. 1.2.

² Witness to the Inquiry.

The Inquiry undertook work to clarify and validate the underlying premise of the Inquiry – that is, that the building and construction industry continues to experience a high and unacceptable level of insolvencies across the sector and that there is a clear need to provide better protection to subcontractors. The sections immediately following this introduction confirm the sound reasons which prompted the NSW Government to establish this Inquiry.

It should also be stated early in this Report, that a vast and important body of work covering the issues considered by this Inquiry and considerably more, already existed. This Inquiry acknowledges the invaluable work and the findings of the Cole Royal Commission into the Building and Construction Industry (the Cole Royal Commission), the Gyles Royal Commission into Productivity in the Building Industry in NSW (the Gyles Royal Commission) as well as the numerous other inquiries that governments have initiated over what is now many years. These reports have served the Inquiry well in terms of setting out the fundamental characteristics of the building and construction industry, confirming the long standing nature of the problems it faces, and providing critical analysis of some of the proposed reform options.

Most of all, they have served as repeated confirmation of the need for a continued focus upon the need for targeted reforms in the sector.

The Terms of Reference of the Inquiry do not provide for the investigation of any particular insolvency event. While it has been necessary and instructive to consider and analyse the number and nature of insolvencies in recent times, including some that have been widely reported on, it has not been the role of the Inquiry to make findings in relation to any specific insolvency.³

Similarly, the Inquiry was not established to specifically review government tender processes or make recommendations on the contract management of government construction work. A separate Task Force was established at the same time as this Inquiry to report to government on these issues. Readers of the Discussion and Issues Paper released by the Inquiry on 12 October 2012 (“the Inquiry’s Discussion and Issues Paper 2012”) will nevertheless understand that the Inquiry considers that a comprehensive analysis of the problems associated with the industry must include reference to government as a client/owner/principal and consider the manner in which it engages industry, the effect of policies and tender processes on the parties in the contracting chain and the expected role of government in setting an appropriate benchmark for fairness, value for money and quality.

Those who have assisted

The Inquiry extends its thanks to all those who have made submissions, completed surveys, appeared before the Inquiry and otherwise generously contributed their time, efforts and advice. The assistance and expertise of those individuals should provide the Government

³ See the Inquiry’s Terms of Reference in the appendices section of this Report.

with a significant degree of confidence that the Report is both well informed and that the key proposals have been tested by debate with those who fundamentally understand the nature of the building and construction industry.

The Inquiry wishes to pay tribute to Canadian and United States colleagues who repeatedly gave their time and expertise in the form of carefully prepared briefs and telephone conferences, free of charge to assist the Inquiry. The savings to the people of New South Wales as a result of the generosity of those persons is considerable.

Special mention must also be made of the Industry Reference Group which played an important role in ensuring that the interests of the many different sectors they represent had a direct voice that could be heard by the Inquiry. The Inquiry also received advice from the NSW Small Business Commissioner, a strong advocate for small business operators in this State.

The Chair acknowledges the important contributions of the following people. The Inquiry was assisted by young lawyers Emma Essey and Greg Holden. Ms Kristine Eslick, Project Officer, was a tower of strength as she deftly moved into and mastered new fields for her, law and construction. The Project Director was Jeremy Tucker, from the Department of Finance and Services. His contribution was outstanding.

The approach of the Inquiry

The Inquiry was structured in a way which abjured the traditional methods of evidence-in-chief cross examination, representation by lawyers and so on. Those who gave evidence, chose who to bring with them to the Inquiry when they gave their evidence to the Inquiry. The work of the Inquiry was characterised by a lack of legal manoeuvring.

When, for example Mr Geoffrey Reed came to give evidence to the Inquiry, a decision for which he must be given credit, he was warned that on a conservative view of things the most prudent course for him might be to decline to give any evidence. He was reminded that the Inquiry did not have any powers to compel the production of documents or the attendance of witnesses or any power to punish for contempt.

The Inquiry's approach was dialectical and involved testing propositions with witnesses, sometimes exchanging letters, emails, telephone conversations and where appropriate if witnesses were speaking about subjects which they considered to be sensitive,⁴ they were given an assurance that 'Chatham House' rules applied. Persons assisting the Inquiry were also advised before any of their evidence was quoted they would have an opportunity to vet the quotes and to ensure they were both accurate and contextually sound.

⁴ Unless of course members of the Inquiry were subpoenaed to give evidence.

In this way and from time to time during debates with particular witnesses, the Inquiry was able to establish a direct and open relationship with those with whom it worked. It is accurate to say that the Inquiry was not adversarial nor was it inquisitorial. The Inquiry was inquisitive. Its methods were not inquisitorial.

After the Inquiry had been in progress for some time and the low hanging fruit had been picked, when the issues had become clearer and the difficulties associated with each issue had become more apparent, the process subtly changed so that people who came to the Inquiry in the early stages were reinvented to express their comments and opinions upon preliminary views which were formulated by the Inquiry as its work continued.

That process culminated in the preparation and dissemination of the Inquiry's Discussion and Issues Paper 2012, which in several sections emphasised its role as a lightning rod to attract further comment, views, opinions, evidence and submissions.

The compilation and structure of the Report

At the forefront of the Inquiry's response to the Government's Terms of Reference must be placed the recommendation that the Queensland model⁵ is necessary to be implemented.⁶ It is rare to find unanimity upon any issue in a chattering society such as ours, however all those who gave evidence to the Inquiry from all sections of the industry with the exception of the Housing Industry Association⁷, agreed that it was an essential part of any reform package to bring in a licensing model and regulatory structure along the Queensland lines.

The Queensland model presents the only solution to the problem of preventing insolvency *in the first place*. The construction trust is important because it operates in a remedial manner *after* insolvency has begun to cause its problems, yet the best defence to the ills, ailments and undesirable consequences which gave rise to the establishment of this Inquiry, must be the Queensland model. The Inquiry cannot place too much emphasis upon that vital conclusion.

That recommendation is placed at the forefront of the Inquiry's work because it aligns almost perfectly with the causes of insolvency. The most effective way to ensure a healthy industry is to ensure the healthy condition of those who aspire to participate in the industry. That is

⁵ Underpinned by the *Queensland Building Services Authority Act 1991*.

⁶ Subject to one important reservation outlined in the 'Statutory Construction Trust' section of this Report.

⁷ It seems that the Housing Industry Association (HIA) views on the Queensland model are largely shaped by the opposition to the insurance role being included in the model. The HIA sets out its views on the Queensland model in its submission to the Inquiry into the Operation and Performance of the Queensland Building Services Authority at http://www.parliament.qld.gov.au/documents/committees/THLGC/2012/INQ-BSA/submissions/BSA_120920_Submission_38.pdf

what is done in Queensland and it is there that it has had its effect upon reducing the number of disastrous insolvencies in the building and construction industry.

The Queensland approach addresses the proven causes of insolvency in the industry, low or non-existent barriers to entry, lack of insulation from the vicissitudes of the industry and the economic cycle, poor financial disciplines, lack of business sophistication and poor payment practices, by the establishment of a compulsory financial backing requirement which places each licensee in an appropriate place in the licensing ladder to execute projects it has the appropriate financial backing to tackle.

The keynote to the Inquiry's approach has been to listen carefully to the voices of those from all sectors of the industry who have come to give evidence and make submissions. Over 120 meetings have been held in 90 days. Where complaints or questions have been addressed about some of the Inquiry's possible solutions, those have been analysed to determine whether they have any validity and if so then they have been taken into consideration in the formulation of a recommendation which can go some way to accommodating the complaint.

The Inquiry has trialled some of its proposals using diagrammatic illustrations, written to interested parties, workshopped through possible solutions in meetings with the aid of whiteboard analysis and has presented its views to a large number of people in meetings.

Through a combination of all of those approaches what the Inquiry has hoped to achieve is a position in which anybody who was likely to be affected by one or more of the recommendations which were in a process of incubation, had an opportunity to be closely involved in the development and final formulation of those recommendations.

After the dissemination of the Inquiry's Discussion and Issues Paper 2012 and the expiration of any sensible period for written comments on the Paper, the process of returning from time to time to particular persons for further views and opinions, continued. Many submissions have been received and reviewed in the last several days of the Inquiry.

The whole of that process culminated in the discussions of possible recommendations with a large number of people before this Report was completed.

During that time the Inquiry took the view that nothing was to be gained by keeping its latest conclusions or current thinking to itself, and everything to be gained by taking them out into the fresh air and discussing their strengths and weaknesses.

Method and approach to the Report's conclusions

It is not the aim of an Inquiry such as this to set out to convince in an argumentative sense those who read the Report to adopt the conclusions of the writer. Rather the purpose and the best and highest use of a report such as this should be to lay out the evidentiary basis for what

follows. Where there are a wide range of matters which are not in the strict forensic sense, matters of evidence, or matters of fact, but which are matters of opinion, then those opinions are of considerable importance to Government and their existence and the reasons therefore are a critical matter to be taken into account by Government when reading the Report.

To take the most extreme case, it may be for example that after careful consideration of the whole of the Report and when policy makers themselves apply their minds to different questions to those which lay before the Inquiry, they may form the view that for whatever social, financial, policy or political reasons, some or all of the recommendations should not be adopted. That of course is an inevitable part of the political process but the point to be made is that any useful report should satisfy a number of functions, one of which is to set out the basis for the formulation of an alternative view and equip the reader to form that view.

The Report should record the work of the Inquiry so that its connection with the Terms of Reference upon which the Inquiry has based its work may be clearly established. Secondly, the report should make clear what matters of fact it considered to have been proven to its satisfaction. Thirdly it should record clearly the fact, where there is evidence of a fact which the Inquiry did not accept. Fourthly, the Report should provide a record and a commentary upon those matters of opinion which were the subject of submissions to the Inquiry. Fifthly, and after ensuring all the view points are collected together in the Report so that the Government may see for itself what matters were relied upon by the Inquiry in coming to its conclusions, the Report should paint the overall picture so that the Government and its advisors are fully equipped and enabled to draw conclusions which might be contrary to those drawn by the Inquiry. In that way the Inquiry's utility cannot be short circuited or diminished simply because a reader of the Report came to a different overall conclusion. Turning points or tipping points should be identified.

The Inquiry should endeavour to critically analyse and present its own analysis upon those questions where the opinions and the interests of those who made submissions to the Inquiry are at variance with each other. There is an old saying which warns against the dangers of getting drunk on one's own beer. That is a danger which must be heeded by any Inquiry such as this, which is charged with the task of reporting to the Government rather than endeavouring as an end in itself to persuade the Government of a particular position and making that objective the primary aim of the Report.

The reasoning of the Inquiry and the nature and character of its conclusions as they bear upon the matters under analysis, will of course be matters of considerable importance for the Government and if the Inquiry's arguments are compelling then absent a more compelling non-legal reason to adopt those recommendations, the constituency and any knowledgeable outside observer may expect that the recommendations will be considered as they inevitably will, with the utmost care. If once that is done, the Government and its policy advisors come to the conclusions that the recommendations are sound then that is one thing. However it is quite another for the Inquiry to take on the mantle of advocate, simply for the purpose of endeavouring to bring the mind of others into alignment with the conclusions drawn. One way of putting the matter correctly in the view of the Inquiry, has been to ensure that after

satisfying itself that those affected by a possible recommendation have had ample opportunities to express their views about proposed recommendations, the Inquiry should and does, set out the contrary view expressed by those affected.

The reader of the Report should be gently guided along the path so that at a critical point in the Inquiry's reasoning it will be equipped to utilise the work of the Inquiry in order to make useful decisions of its own whether or not it agrees with the final conclusions expressed in the recommendations. If a methodology of that kind is followed then a report, which for the sake of the argument, draws ultimate conclusions and expresses them in the form of recommendations which are not agreed to by the Government and its advisors, will be seen to have been useful and satisfied its high importance as one means of placing the Government in a position to make those decisions of public importance while standing on the shoulders of all of the witnesses who gave evidence, all the material researched and the analysis conducted by the Inquiry. It is hoped that the contents of this Report will make evident that approach and in that event be useful to those readers of all persuasions, inclinations, dispositions and interested viewpoints.

The Need for Change

While views within industry on the manner and scope of reforms that should be implemented by Government to address the issues raised in the Terms of Reference differ, there was little if any strong debate on the need for change. In highlighting the existing regulatory obligations that apply to the housing market, the Housing Industry Association (HIA) asked the Inquiry:

“...to be cognisant of the need to reduce ‘red tape’ for businesses operating in the NSW residential construction industry. Regulatory and administrative burdens strangle businesses in the sector and such circumstances are at odds with the need to stimulate the housing market in NSW. Given this HIA would ask that a conservative approach be taken when considering measures that affect the contractor/subcontractor relationship.”⁸

The Inquiry agrees, particularly when times are tough. Yet if a reform is based upon a balanced view and found to be necessary, so be it. In its comments on payment practices affecting subcontractors, HIA set out its views on bargaining between the parties in this way:

“Subcontractors are independent businesses operating in a free market, subject to the ebbs and flows of industry. One of the advantages of running your own business is that you can choose who you work for and you are able to negotiate the terms and conditions of an agreement including the payment terms.”⁹

⁸ Housing Industry Association, Submission, 2 November 2012, p. 1, para 2.1.5.

⁹ Ibid. p. 7, para 5.1.8.

Through its own reading and research, in meetings and submissions, the Inquiry heard a great deal of the prior work and research associated with previous inquiries and commissions, all pointing towards the continuing need to offer greater protection to subcontractors. That is not to say that there was an absence of disagreement on this question. However the Inquiry has firmly concluded that the views of sectional interests, particularised and considered by this Inquiry, need to be set aside, that the evidence and widespread support for reform be heard by Government, and that work to provide a fairer outcome for subcontractors should commence.

Those unconvinced by the need for change may wish to consider the following. On the same day¹⁰ during the Inquiry, three related events occurred:

- reports of the collapse of a large construction company, Southern Cross Constructions (NSW) Pty Ltd, owing a reported \$42 million to creditors including subcontractors and suppliers;
- a distinguished elderly man who had been a subcontractor for more than 40 years as the principal of a high quality stonemason's business, gave evidence that his business had suffered substantial losses upon the insolvency of head contractors on five occasions during those 40 years;
- the Inquiry was reminded of the repeated lament: “(the) *building industry has become infamous for its non-payment of subcontractors.*”¹¹

Then on 15 November 2012, the Australian Financial Review reported that the “*Building slump claims another victim*”. The Inquiry, through all its work, is familiar with what the article refers to as the:

*“...bidding war for the shrinking pool of work which leaves scarcely any profit margin”*¹²

and its repercussions for the industry. The article refers to a BIS Shrapnel investigation that:

“.....found contractors were exceeding normal bill payment terms, paying creditors after 60 or even 90 days instead of 30.”

The article also states that BIS Shrapnel found that the:

*“... tightening market is forcing many builders to price jobs below cost, in turn lowering margins for subcontractors.”*¹³

On the core issue of what is left for subcontractors the article noted that:

¹⁰ 25 October 2012 during the work of the Inquiry.

¹¹ 1991 Queensland Discussion Paper, p. 73 para 1.1.

¹² Australian Financial Review, “*Building industry slump claims another victim*”, 15 November 2012, p.44

¹³ *ibid.*

“The collapse of a big contractor has a ripple effect, often ruining scores of subcontractors and suppliers. They are last in the queue as administrators, banks and employees have first call on the assets.”¹⁴

It is surely time for reform to be closely examined: the *necessity* for reform has been emphasised repeatedly and the *method* of effective reform has been repeatedly set out in numerous reports. The Inquiry considers that it is time for a close examination of potential and lasting reform that works to protect the interests of subcontractors in the building and construction industry.

A better functioning and fairer building and construction industry can have real economy-wide benefits: a more efficient allocation of capital, enhanced employment opportunities in an industry so important to the NSW and national economies, and better value for money in relation to the Government’s infrastructure and broader capital works program.

A national approach - the “Agreed National Principles”

It was not that long ago that small children and their families from NSW visiting their relatives interstate in Melbourne, were required to tumble out of the train from Central Station in Sydney when the train arrived at Albury, for the purpose of transferring to another train built to accommodate the different gauge of the railway lines running from Albury to Melbourne.

It is heartening therefore to recall what were described as the “agreed national principles” which were endorsed by Commonwealth, State and Territory Ministers responsible for construction at a meeting of the Australian Procurement and Construction Council Inc (APCC) on 15 January 1996. Ministers committed to applying these principles to ‘security of payment’ matters and they were to:

“form the foundation of the programme of national action presented here and being taken across all government jurisdictions.”¹⁵

These principles are obviously of considerable importance to the work of the Inquiry and they entirely endorse and confirm the approach of the NSW Minister for Department of Finance and Services and Minister for the Illawarra, the Hon. Greg Pearce MLC, when on 9 August 2012 he established this Inquiry.

The principles are and should be a lodestar to be followed by the Inquiry, but for present purposes what is of great significance is that the principles agreed then between all Commonwealth, State and Territory Ministers are in almost precise conformity with the Terms of Reference by which the NSW Government established this Inquiry. Such is their

¹⁴ Ibid.

¹⁵ Australian Procurement and Construction Council Inc (APCC), “National Action on Security of Payment in the Construction Industry in Australia – Adelaide 1996”, APCC Canberra (“1996 APCC National Action Report”), p.2.

significance and their relevance to the twin pillars¹⁶ upon which the Inquiry has based all of its recommendations that they should be set out in full:

- 1) ***Participants have the right to receive full payment as and when due;***
- 2) ***All cash security and retention moneys should be secured for the benefit of the party entitled to receive them;***
- 3) *Payment periods lower in the contractual chain should be compatible with those in the head contract;*
- 4) *Outstanding payments to participants, to the extent consistent with Commonwealth and State legislation, should receive priority over payments to other unsecured creditors;*¹⁷
- 5) *All construction contracts should provide for non-payment to be a substantial breach;*
- 6) *All construction contracts should make provisions for alternative dispute resolution mechanisms;*
- 7) ***Only those parties who have the financial and technical capacity and business management skills to carry out and complete their obligations should participate in the industry; and***
- 8) *All construction contracts in the contractual chain should be in writing.*¹⁸

(emphasis added in each case)

The agreed national principles document then goes on to say that:

“These principles of conduct have been adopted by all governments in their dealings with the construction industry. They will be applied through the agreed National Action and the initiatives of individual jurisdictions, many of which are already in place.

Government agencies shall also develop appropriate sanctions consistent with their business activities and the laws applicable in their respective jurisdictions to achieve compliance with the principles.”¹⁹

These statements are a rallying call to action and in the view of the Inquiry are intended to be carefully considered within the exercise in which the Inquiry is involved. Here is an opportunity to again reject the variable gauge railway mentality and to endeavour to draw together the work and the conclusions of a significant number of different organisations and institutions over what has now become a relatively long period. These statements of principle agreed across the Commonwealth of Australia ought to infuse the work of the Inquiry.

¹⁶ The twin pillars are discussed on page 14.

¹⁷ This objective will be achieved by the construction trust

¹⁸ 1996 APCC National Action Report, p.2.

¹⁹ Ibid.

To those national principles the Inquiry adds the ‘twin pillars’ upon which all of its recommendations have been based. Those twin pillars have been found as matters of fact by the Inquiry. They have been made and echoed around Australia in other inquiries over many years.

When considering the way in which to express the overall *theme* of this Report the Inquiry repeatedly referred back to conclusions which had been made by other inquiries which had been repeatedly affirmed in evidence to this Inquiry.

It is a matter of considerable significance in the Inquiry’s view, that Government should be aware of the high significance of repeated unequivocal statements as to the nature of the problem. Quite plainly no one has needed reminding of the importance of the Inquiry’s Terms of Reference or of the problems which have been uncovered and discussed in years past. The recent collapse of Southern Cross Constructions (NSW) Pty Ltd serves to hasten the requirement that legislative intervention be considered.

The causes of security of payment problems in the industry were identified by the Cole Royal Commission in a way which this Inquiry respectfully adopts. The four main problems were identified as:

- 1) *the operation of ‘rogue’ builders, who deliberately delay or avoid the payment of subcontractors;*
- 2) *builders using non-payment of existing claims as a bargaining tool to reduce claims of substance;*
- 3) *builders who are in financial difficulty and who do not have the cash flow to pay subcontractors;*
- 4) *builders that become insolvent and cannot pay the full amount owing to their creditors, including subcontractors.*²⁰

Project failure can be added to that list.

The 2006 Security of Payment in the Tasmanian Building and Construction Industry Report for the Minister administering the *Building Act 2000*, reminded the reader of the position earlier outlined by the statement of the Honourable RE Schwarten Queensland Minister for Public Works, Housing and Racing when he introduced the security of payment legislation in the Queensland Parliament in March 2004 saying:

“While bad debts are not unique to the building and construction industry, the industry is particularly vulnerable to payment problems because it generally operates under a hierarchical chain of contracts. The failure of any one party in the

²⁰ Royal Commission into the Building and Construction Industry, (Terence R.H Cole, Royal Commissioner) *Final Report of the Royal Commission into the Building and Construction Industry*, February 2003, (“2003 Cole Report”) vol 8, p. 231, para 10

contractual chain to honour its obligations can cause a domino effect on other parties resulting in restricted cash flow and in some case insolvency.”²¹

The APCC in 1996 had already recognised the significance of security of payment problems in the industry when it said that:

“The inability to assure payment may occur at any level in the hierarchy. There is a popular perception however, that the worst problems occur with payments from head contractors to specialist sub-contractors and other suppliers further down the contractual chain. As sub-contractors and suppliers provide 80-90% of trade work associated with projects, their risk level of non-payment is high. The problems are worse when a participant higher in a contractual chain becomes insolvent, and when the sub-contractor is indebted to other sub-contractors and suppliers.”²²

It is important to restate and re-emphasise the clear terms of the findings and conclusions of the Cole Royal Commission:

“Security of payment was raised with the Commission during public hearings, in meetings that I held with interested parties, in interviews conducted by commission investigators, and in submissions to the Commission. It quickly became apparent that it is an issue that critically affects the ability of participants in the industry to make a living, and to be rewarded for work that they have performed. During the course of their investigations, Commission investigators have repeatedly been told of the suffering and hardship caused to subcontractors by builders who are unable or unwilling to pay for work from which they have benefited. The subcontractors who experience payment problems are often small companies or partnerships. Frequently they do not have the expertise or resources to enforce their legal rights, because enforcement would require protracted litigation against much better resourced and more sophisticated companies. Consequently, subcontractors that have operated profitably and well for many years can be forced into liquidation through no fault of their own, often with devastating consequences for the owners of these businesses, their families, their employees and the creditors.”²³

The Inquiry respectfully adopts those conclusions. Nothing has changed.

²¹ See the Queensland Legislative Council Hansard, 18 May 2004, pages 71-72. See also Stenning and Associates Pty Ltd and the Work Lab Inc, *Final Report for the Minister Administering the Building Act 2000- Security of Payment in the Tasmanian Building and Construction Industry, 2006* (“2006 Tasmania Security of Payment Report”), p. 11.

²² 1996 APCC National Action Report, p. 1.

²³ 2003 Cole Report, vol 8, p. 229, par 2.

The Flying Dutchman

The position described in that passage above quoted from the Cole Royal Commission final report has been mirrored precisely by the research, oral evidence, submissions and discussions during the course of this Inquiry. Some might say that if the issues raised are not dealt with after the emphatic and repeated descriptions of the same problem over more than 20 years, the debate will come to starkly resemble the Flying Dutchman, the legendary ghost ship that can never make port, doomed to sail the oceans forever. Repeated references to the same payment problems in reports and inquiries may be likened to the glowing ghostly light reported by those who claim to have sighted the vessel in the last century. It is said that when hailed by another ship, the crew of the Flying Dutchman attempted to send messages to land or to people long dead. Messages of that kind have emanated from inquiries and commissions for too long it may be said. Perhaps the time has come to ensure the problems are addressed with more determination than has been the case in the past.

The evidence to warrant legislative intervention

The Inquiry has heard evidence from a wide variety of persons and organisation intimately involved in the building and construction industry. Overwhelmingly, witnesses to the Inquiry have spoken of the significant damage and hardship caused to subcontractors as a consequence of the insolvency of building contractors. It is true that it is not possible, unless at great expense, to quantify that damage, yet in the present climate it is sufficient to look at Reed Constructions Australia Pty Ltd, St Hilliers Construction Pty Ltd, Southern Cross Constructions (NSW) Pty Ltd and one or two others for the purposes of firmly establishing a basis from which it can be concluded that the problem is substantial, recurrent and results in unacceptable consequences for innocent participants in the industry. All of the requirements for a legislative intervention as foreshadowed by the Inquiry's Terms of Reference have been established. The Inquiry has absolutely no reason to think that the detailed examination of the problem conducted by the Cole Royal Commission does not continue to accurately describe the situation at present. The Inquiry has every reason for thinking, on the basis of credible evidence given to it that the position revealed by the Royal Commission investigators and summarised by the Royal Commissioner in the above quoted passage is an accurate representation of the present position.

If anyone remained in any doubt about that otherwise incontestable conclusion, then the demise of Southern Cross Constructions (NSW) Pty Ltd during the course of the Inquiry ought to have put those doubts to rest.

Subcontractors must help themselves

Having said that, the Inquiry clearly understands that while the insolvency of a head contractor can have a devastating impact on subcontractors and often lead to their own insolvency, there are large numbers of subcontractors across all sectors of the industry whose

own practices lead them directly into insolvency. There is a pressing need for subcontractors to be better informed and able to help themselves. This managerial incompetence was identified in the Inquiry's Discussion and Issues Paper 2012 and is addressed in the Inquiry's recommendations.

The key principles underpinning the Inquiry's findings

The Inquiry fairly and squarely bases its overall conclusions upon a support consisting of two strong pillars. They are:

- 1) The principle that when money is paid by a principal (owner) to a head contractor and that money is paid as a consequence of subcontractors having carried out the lion's share of the work and supplied materials to the project, then it is against the good conscience of the community, to stand by and tolerate what has been a repeatedly demonstrated inability of the existing legal system to protect subcontractors against the default and the financial mismanagement of others who would not, but for the efforts of the subcontractors, be paid the money in the first place. That is the first major pillar upon which the Inquiry rests all of its ultimate conclusions.
- 2) The second major pillar which, like the first, is firmly and repeatedly supported by all of the evidence given to the Inquiry, is that given the intentions and expectations engendered in the minds of subcontractors by the contractual promises made by the head contractor to pay an agreed sum for their work and materials, and given the work carried out by subcontractors in reliance upon those promises, all of which is known by the principal, payments or leakages from the project payment cycle to any of the five 'leaked' destinations outside of the project pyramid, is unacceptable. These external payments may be broadly summarised as:
 - paying off the tail of other jobs or paying claims relating to other jobs;
 - paying off or reducing a bank overdraft or other loans or debts;
 - purchasing property;
 - discretionary expenditure of a personal nature; and
 - perhaps, most importantly of all given its susceptibility to cyclical movements in the financial market and the economy generally, collateral development activity engaged in by the builders.

These five destinations described in detail later in this Report are the means by which the rights of subcontractors to be paid are compromised. They are unacceptable and in the view of the Inquiry each must be placed beyond the power of the head contractor to accomplish.

From these two unassailable propositions, almost the whole of the Report proceeds. Unless they can be successfully challenged, unless they are impugned in some significant manner, then a powerful basis has been established in support of the recommended reforms.

Unwilling bankers

Subcontractors should no longer be unwillingly drafted into service as bankers for the head contractor and indirectly, for the principal. Project financing should not be made to rest upon their shoulders. They are inadequate for the task in any event. That result has only been allowed to continue in the past because of the weak bargaining position in which subcontractors have found themselves. On this issue the Inquiry's Discussion and Issues Paper 2012 noted the commonly held view within the subcontracting sector of the construction industry as a:

“bottom up financial model resulting in a situation where the subcontractor is extending what amounts to an unsecured, interest-free loan” to the contractor. At the same time the subcontractor is also paying interest on its overdraft at the bank while it waits for payment from the contractor.”²⁴

Referring to the payment practices of an interstate contracting firm, one subcontractor told the Inquiry, simply, that:

“We are not a bank.”²⁵

An analysis of risk and the relative bargaining power of the contracting parties is provided in later sections of this Report.

Why a new model is appropriate

After detailed discussions with those who are responsible for the administration of the *Queensland Building Services Authority Act 1991* (“QBSA Act”) and having examined the on-year accounts since the Authority was established in 1991, the Inquiry has concluded that there is a sound basis upon which to expect that a prospective NSW Building and Construction Commission could be substantively but not completely, self-funding in much the same way as occurs in Queensland. The discussion whether or not to do so, will of course depend upon the necessary cost-benefit analysis.

The essential question that arises for the Inquiry when giving detailed consideration to the Queensland model is whether the key provisions of the QBSA Act can be disentangled from the statutory structure in which they are set and cherry picked to be included within, for example, the NSW *Building and Construction Industry Security of Payments Act 1999* (“SOPA”).

²⁴ Witness to the Inquiry.

²⁵ Witness to the Inquiry.

The Inquiry has given close attention to those matters and for the following reasons has formed the view that such a disentanglement is not possible and that the only proper way in which to implement the vital function of financial auditing entailed by the necessity for building contractors to financially back each project adequately, is to bring the essential Queensland elements together under the control of a body which would it is suggested, be called the NSW Building and Construction Commission. The word ‘building’ is appropriate to involve the home building sector and the word ‘construction’ is appropriate to embrace all of the many and varied tasks of construction with which the industry is involved.

The Inquiry has noted the concerns expressed by some, of the potential hazards that exist in ‘blending’ regulatory functions such as licensing and an insurance function, within the one agency. It is not the role of this Inquiry to delve into matters of governance and the operation of a body that the NSW Government is yet to deliberate on. It is sufficient to say that any agency or statutory authority charged with the duties that would be expected to fall within a Building and Construction Commission, must have ingrained in it, the essential elements of good governance, reporting, and auditing and a meaningful separation of functions where there is the possibility of a real or perceived conflict of interest. The key elements of interest to the Inquiry are the licensing of commercial builders coupled to the financial backing requirements that exist in Queensland.

It is also important to state that the home warranty insurance scheme in NSW is set up in a fundamentally different manner to how that insurance is administered in Queensland and for that reason, the criticisms that some make of the Queensland model, simply do not apply to the current situation here in NSW, nor of the Inquiry’s proposed new model. The Inquiry wishes to make clear that its role has not extended to any evaluation of home warranty insurance in NSW or any other jurisdiction.

Support for licensing, financial requirements and a ‘NSW Building and Construction Commission’

The recommendation to bring all the functions and activities relating to building and construction within one statutory body does not raise up a new concept. Support for such a commission has existed for some time.

The Master Builders Association (MBA) is a distinguished and active body whose views are entitled to considerable respect. The MBA has more than 30,000 members in the building and construction industry and has for a considerable time supported a more consistent, co-ordinated and integrated approach to the issues and challenges that face the industry. The Chief Executive Officer of Master Builders Australia, Mr Wilhelm Harnisch, made clear his organisation’s support for change when he said:

“[the]Master Builders’ Board has the aspirational goal of the introduction of a system in each State and Territory based along the broad lines of the Queensland

registration system, underpinned by statute along the lines of the Building Services Authority Act 1991 (Qld).”²⁶

As Mr Harnisch noted in his letter, it is essential that the industry is properly consulted on all reforms decided upon by government, including on the setting of criteria for financial requirements. Mr Harnisch stated that the MBA believed that requirements for financial underpinnings of a builder license:

“would be a positive step for dealing with the insolvency matters in the industry.”

During the Inquiry, the NSW branch of the MBA, a member of the Inquiry’s Industry Reference Group, made its position clear on how best the many different regulatory and other parts of the industry should be managed:

“Master Builders Association policy position is for further consolidation of government departments, agencies and their functions. Furthermore, in recognition of the importance of the building and construction industry, a specific ministerial portfolio for the industry needs to be created.

Master Builders advocates that an Independent Building Commission is a deserving response to the industry’s contribution to the state economy. This Commission would draw together the current fragmented approach of various departments and government agencies to deliver efficiencies and eliminate current duplication.”²⁷

On this issue the MBA were joined by an overwhelming majority of those who met with the Inquiry.

The Inquiry has also noted the establishment by the NSW Government in July 2011, of an independent panel to undertake a review of the planning system in NSW. The panel has been tasked with creating a new planning system. While not asked to consider planning issues, the Inquiry took an interest in the views expressed by stakeholders on the regulation of the building and construction industry. Noted in Volume 1 of the Independent Panel’s Review Report released in May 2012, were the:

“.....number of submissions made to us proposing we should recommend sweeping further regulation of the building industry. In part, this arose from community concerns about the activities of private certifiers but also, in significant part, by proposals advanced by the Building Professionals Board for fundamental change to the present regulatory regime for the building industry. We have not had the mandate, time or expertise to deal with the wholesale change suggested to us for regulation of the building industry. We have concluded that this is a separate matter

²⁶ Master Builders Australia, Submission dated 20 November 2012, p. 1.

²⁷ MBA NSW, submission dated 5 November 2012, p. 15.

*that the Building Professionals Board may wish to take up directly with the government, as it is not a matter appropriate for recommendation by us.*²⁸

NSW Building Professionals Board

The Building Professionals Board was established under the *Building Professionals Act 2005* (NSW) to among other things, accredit persons under the *Environmental Planning and Assessment Act 1979* (NSW) and is responsible for the promotion and maintenance of standards of building in NSW. The Board works to improve the quality of building construction and subdivision in NSW by regulating and educating building and subdivision certifiers.

In its submission to the NSW Planning Review, the Building Professionals Board argue that regulation of building practitioners is:

*“fragmented..... and does not comprehensively cover key professions.....”*²⁹

The Board in its submission goes on to state:

*“In other states, the regulation of building professionals is undertaken by one government agency. This provides a coordinated approach to monitoring the activities of the building profession, reporting on the status of the industry.”*³⁰

The Inquiry finds it difficult to improve on the following rationale provided by the Building Professionals Board for establishing a building commission in NSW:

“In 2009-2010, 23% of all Australian building approvals, \$18.64 billion worth of construction, was approved under the NSW local development approval system. However, no single body or authority is responsible for the regulation and control of persons involved in the design, approval, construction and certification of this work.

The absence of a single regulatory body has attributed to ongoing problems in the industry, including:

- *accountability and liability of builders and other building practitioners*
- *quality of building outcomes*
- *cost and efficacy of consumer protection measures*
- *confidence of investors and builders*
- *consistency of regulation*

A building commission would allow the NSW government to deliver:

- *a ‘one stop shop’ for consumers and industry*

²⁸ Moore, T. and Dyer, R., *The Way Ahead for Planning in NSW, Recommendations of the NSW Planning System Review*, Volume 1-Major issues, May 2012, p. 13.

²⁹ Building Professionals Board, Submission to the NSW Planning Review, 4 November 2011, p. 8

³⁰ Ibid.

- *a single integrated agency to oversee and lead the industry*
- *greater confidence in building and investing in NSW*
- *consistency in building control and regulation*
- *improved building quality and industry outcomes*
- *continued professional development and training.*³¹

The NSW Building Regulations Advisory Council

The NSW Building Regulations Advisory Council (BRAC) is comprised of industry, government and professional representatives and provides non-binding advice to the NSW Department of Planning and Infrastructure. Its advisory role predominately relates to technical matters of building and development in NSW.

In its submission of 29 February 2012 to the current NSW Planning Review, BRAC refers to the models currently operating in Queensland and Victoria as examples of administrative and legislative systems that would create an environment in which there would be more effective regulation of the building and construction sector.

The membership of BRAC consists of:

- Property Council of Australia
- Master Builders Association
- Housing Industry Association
- Australian Institute of Architects
- Engineers Australia
- Australian Institute of Building Surveyors
- Australian Institute of Building
- Sydney City Council
- Local Government and Shires Association
- Fire and Rescue NSW
- NSW Rural Fire Services
- Department of Commerce (now the Department of Finance and Services)
- Department of Housing
- NSW Health³²

BRAC favours the type of model and structure that the Inquiry is recommending, stating in its submission that:

“A new building act should also be administered by a specialist agency such as a building commission similar to the Victorian or Queensland models.

A building commission would capture and more effectively administer all building

³¹ Ibid, p. 37.

³² NSW Building Regulations Advisory Council, submission to the NSW Planning Review, dated 29 February 2012, p. 22.

control and regulation aspects including:

- a) the Home Building Act, the Strata Schemes Management Act, contractor licensing, complaints investigation and plumbing control currently under the jurisdiction of the Office of Fair Trading;*
- b) the Building Professionals Board (and associated committees and functions);*
- c) parts of the Department of Planning and Infrastructure i.e. the Building Systems Unit and other related sections;*
- d) some functions of Fire and Rescue NSW and the NSW rural Fire Services relating to the approval or concurrence functions for building approvals and occupational certificates; and*
- e) The relevant parts of other Acts and Regulations that relate to building control such as the Public Health (Microbial Control) Regulation.”³³*

The submission then went on to say that:

“It is important to have consistency with other states and territories in the licensing requirements for the various contractor disciplines throughout the building industry. It is also important to have special licensing or registration of professionals involved in key areas of the building certification process. A separate statute to the planning laws will facilitate this process and system.

In addition, any new department or agency responsible for administering a new building act should also be headed by a senior Minister and be adequately resourced to ensure that full and appropriate support is provided to this important sector of the NSW economy.”³⁴

The Inquiry is of course aware of the public policy and public administration considerations which are always at play in current political debates. The Inquiry is also aware of the financial and budgetary restraints which require governments of the day to resolve competing priorities and competing claims from funds which are inadequate to satisfy the totality of those claims. In spite of that it must in the view of the Inquiry, be borne in mind that a group of measures unaccompanied by any requirement obliging contractors to meet financial stability and net asset levels will seriously weaken the recommended reform structure.³⁵

³³ Ibid, p. 6.

³⁴ Ibid, p. 6.

³⁵ This critical conclusion is further developed in this Report under the heading, “The architecture of the recommendations”.

Background

Why an inquiry into construction industry insolvency?

In its announcement of an Independent Inquiry into Construction Industry Insolvency, the NSW Government made reference to the significant and ongoing adverse effects of insolvency on workers, the economy and unsecured creditors such as subcontractors. Reference was also made to the current fragility of the construction sector and the need for a strong construction industry to support investment, jobs and the Government's own infrastructure program.³⁶

The continuing high number of insolvencies in the sector, their effect on unsecured creditors such as subcontractors, together with the dead weight loss associated with stalled construction projects provided the impetus for the Government to establish this Inquiry.

The principle focus of the Inquiry has been to consider and make recommendations on options that would better protect the interests of subcontractors including suppliers. However that is not the totality of the Inquiry's work.

Previous inquiries

The issue of better protection for subcontractors has been the subject of intense discussion and debate at Commonwealth and State Government levels for many years. The interrelated issues examined by a number of inquiries and reports focussing on the construction industry have included security of payment, cash flow and payment practices, trust moneys, retentions and risk. The Inquiry has considered the substantial body of existing work, and this Report makes numerous references to findings of fact and other material that are part of this work.³⁷

The Terms of Reference

The Inquiry has carefully considered the Terms of Reference and the matters it is obliged to assess and report on. A keen focus of the Inquiry has been to ensure that it avails itself of past research and findings together with the particular and current views on the Terms of Reference of those who build, those who represent the builders and those who regulate the industry.

Security of payment legislation

Each jurisdiction in Australia has enacted security of payments legislation. This legislation is generally based on the NSW *Building and Construction Industry Security of Payments Act 1999* (SOPA). Each Security of Payments Act across Australia has at its core, the underlying premise or aim of facilitating cash flow in the industry for subcontractors, or those typically

³⁶Hon. Greg Pearce MLC Minister for Finance and Services and Minister for the Illawarra, Media Release – "Government Inquiry into Construction Projects", dated 9 August 2012.

³⁷ The appendices (including the bibliography) section of this Report contains a list of reports of previous committees and inquiries that made findings on at least some of the issues considered by this Inquiry.

at the foot of the contracting chain. This Report will document the need for amendments to be made to SOPA that will enhance and extend its operation as well as its accessibility to subcontractors. These amendments are part of an overall suite of recommendations that aim not only to enhance and promote cash flow in the industry in line with the original aims of SOPA, but also to protect moneys owed to subcontractors in the event of an insolvency of the head contractor, including retention moneys.

The building and construction industry

The Inquiry's Discussion and Issues Paper 2012 acknowledged the different sectors that operate within the building and construction industry. Within these sectors, there exists a range of factors, some unique, others common across the industry as a whole, that must be analysed when first identifying the problems to be addressed and then importantly, in considering the most appropriate way to remedy those problems and to address the underlying causes. The Inquiry agrees with the submissions of HIA and the MBA on the need for consideration of the characteristics of the home building sector and its overall importance.

Some of the questions the Inquiry has considered when looking at the extent, cause and impact of insolvency are:

- is the problem confined to, or more prevalent in one or more sectors of the industry;
- are there particular behaviours or practices that exist in one sector that can be labelled as major contributing factors of insolvency; and
- what regulation currently exists in the different sectors that has the potential to ameliorate the effects of insolvency or address the root cause?

A whole of industry approach is typically desirable from both an efficiency and equity position. However particular sensitivities within a sector together with a clear understanding of where the incidence and impact of the problem is greatest may result in the adoption of a more flexible approach to reform.

The matter of unintended consequences of reform must always give rise to much thought and discussion. The Inquiry notes that in considering the recommendations of this Inquiry, there is some further work to be done in this regard, and that work is highlighted.

The whole of industry approach should also influence the manner in which reforms are implemented and the structure of any authority or agency which administers the regulatory framework. An integrated approach to the regulation of this sector has obvious benefits and will be discussed in later sections of this Report. Such an integrated approach and a targeted approach to both the regulatory framework and education and enforcement activities are not mutually exclusive and can at the same time, be a powerful tool for Government to ensure meaningful oversight while providing benefits for industry participants.

Insolvency: the story in figures

The Inquiry engaged the services of BIS Shrapnel to provide an analysis of insolvency statistics and provide a clearer picture of the causes of insolvency, sector incidence of insolvency and some forecasting data.³⁸

The BIS Shrapnel Report confirmed that insolvency in NSW construction has accelerated over the past few years. This has included a number of high profile contractors and also hundreds of smaller subcontractors. Key issues contained in the BIS Shrapnel Report include:

- *“The industry recorded the highest number of insolvencies of any defined industry for the financial year 2011/12, a total of 1,113 or 24.7% of external administrations reported to ASIC across NSW*
- *By size, a majority of the insolvencies being recorded are by small contractors and sub-contractors, entities with assets of less than \$10,000”³⁹.*

BIS Shrapnel found that:

“The surge in NSW insolvencies has been driven mostly by the prolonged stagnation in residential construction, exacerbated by the simultaneous slowdown in several key non-residential types:

- Engineering construction has not been a significant contributor to the recent insolvency surge in the NSW industry;
- the residential sector is the biggest contributor, with both detached houses and multi-residential building (medium and high density apartments) both helping drive the rise in insolvencies;⁴⁰
- in non-residential construction the simultaneous slowdown in key areas such as office, retail, warehouse and hotel construction has worsened the situation since the GFC.”⁴¹

The Inquiry notes that there is some lack of clarity on where the largest proportion of insolvencies in the industry exists. The article in the Australian Financial Review on 15 November 2012, referred to earlier, quoted the principal of a contractor debt recovery agency as stating:

“There are much more failures in the commercial and industrial sectors than in residential, and the domino effect from bigger companies to subcontractors will continue. It will increase because it’s harder for these companies to win work and

³⁸ BIS Shrapnel Report, *NSW Construction Activity and Insolvencies*, November 2012

³⁹ *Ibid*, p. 1.

⁴⁰ *Ibid*. This figure is a cause for great concern to the Inquiry because of the effects upon ordinary Australians, most of whom are embarking upon the biggest venture of their lives and it is further justification for all such issues being brought under a Building and Construction Commission – see recommendations.

⁴¹ *Ibid*.

they are having to take on projects at a loss. They go in under priced at tender and then come out insolvent.”⁴²

It is important to note that a reduction in available work will always work to amplify the pressures on businesses operating in a competitive industry. In an industry such as building and construction where profit levels are relatively low compared to many others, a reduction in the volume of work inexorably leads to tighter margins, greater risks and an increase in the number of insolvencies.

The role of the construction industry in NSW

The health of the construction industry as a major employment sector and overall contributor to the NSW economy will always be of concern to governments. Furthermore, the health of the industry can have serious impacts on the NSW Government’s own construction program. In his 2012/13 Budget speech, the NSW Treasurer, the Hon. Mike Baird MP announced that over the four years to 2015-16, the NSW Government will spend on average \$1 billion more a year on infrastructure than over the past four years.⁴³ The Government, in establishing this Inquiry, set out the inter-related aims of ensuring a better deal for subcontractors in the industry while at the same time managing and protecting its own construction program.

⁴² Australian Financial Review, 15 November 2012, p. 44.

⁴³ NSW Treasurer, 2012/13 Budget Speech, Hansard.

Construction Industry - Contribution to Gross State Product

Year	Construction Industry gross value added: Current prices; NSW (millions)	Construction Industry gross value added; proportion of Gross State Product; NSW	Total all industries; Gross state product: Current prices NSW (millions)
Jun-2001	28457	11.2%	254609
Jun-2002	27576	10.4%	265406
Jun-2003	31365	11.2%	279960
Jun-2004	32492	10.9%	297894
Jun-2005	33137	10.5%	314331
Jun-2006	33603	10.2%	330445
Jun-2007	32269	9.2%	350715
Jun-2008	34698	9.2%	375593
Jun-2009	34070	8.7%	392445
Jun-2010	34861	8.5%	410774
Jun-2011	35376	8.1%	438456

Source: Australian National Accounts: State Accounts (cat. no. 5220.0)

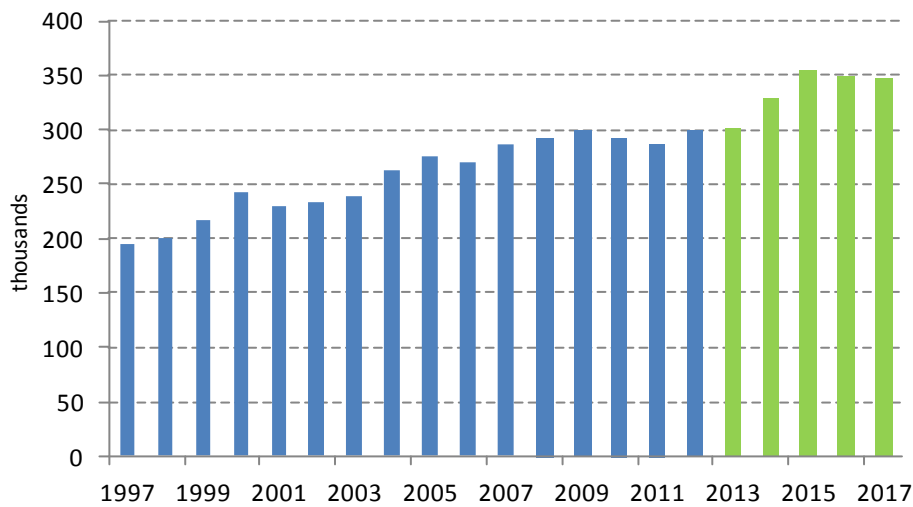
Construction Industry - Employment Figures - NSW

Year	Employed Total Construction	Construction - Proportion of Total Employed	Employed Total
May-2002	232.9	7.6%	3063.0
May-2003	242.3	7.7%	3133.7
May-2004	275.3	8.7%	3167.5
May-2005	268.7	8.4%	3209.2
May-2006	276.4	8.4%	3279.3
May-2007	290.1	8.6%	3357.8
May-2008	289.3	8.4%	3449.0
May-2009	298.7	8.7%	3446.6
May-2010	300.2	8.6%	3490.2
May-2011	295.5	8.2%	3590.6
May-2012	308.7	8.5%	3619.3

Source: Labour Force, Australia, Detailed, Quarterly (quarterly) (cat. no. 6291.0.55.003)

It is encouraging to note, that as a result of expected increases in construction activity in NSW, BIS Shrapnel forecast improved employment in NSW in the industry over the next few years, as residential and non-residential construction recover.

Construction Employment, Number of Employees - New South Wales



Source: BIS Shrapnel, ABS 44

Conduct of the Inquiry

Establishing the Inquiry

The NSW Government announced the Inquiry on 9 August 2012 and appointed Bruce Collins QC as Chair. The Inquiry commenced work on 13 August 2012.

The Terms of Reference are included in the appendices section of this Report and provide that the Inquiry is to report within three months of being established.

The Inquiry conducted its work from private rooms leased from the Land Property and Information Office in Queens Square, Sydney.

Call for submissions - Terms of Reference

On 16 August 2012, the Inquiry called for submissions based on the matters raised in the Terms of Reference. Advertisements were placed in the Sydney Morning Herald, The Australian, Australian Financial Review, the Daily Telegraph and 22 regional newspapers across NSW.

A total of 83 submissions were received from a wide variety of industry participants. The Inquiry also received submissions from a number of organisations representing builders, contractors and subcontractors and employees including the:

⁴⁴ BIS Shrapnel Report, November 2012, p. 15, chart 19.

- Australian Institute of Quantity Surveyors;
- Australian Constructors Association;
- Construction Forestry Mining and Energy Union (NSW);
- NSW Business Chamber;
- Civil Contractors Federation (NSW);
- National Electrical Contractors Association – NSW Chapter;
- Master Plumbers Association NSW; and
- Housing Industry Association.

Submissions were also received from the NSW Small Business Commissioner, authorised nominating authorities under SOPA, barristers, solicitors, engineers, quantity surveyors, consultants, insolvency and business reconstruction experts and accountants.

Release of the Discussion and Issues Paper

The Chair of the Inquiry released the Discussion and Issues Paper on 12 October 2012. The release of the Paper was advertised on 17 October 2012 in Sydney metropolitan newspapers, Australian Financial Review and 21 regional papers across NSW between 16 and 20 October 2012.

The purpose of the Paper was to put directly to industry and all interested parties, the options for reform that were to be considered together with some accompanying detail and to provide an opportunity to support, oppose, dispute or provide alternatives to those options.

The Paper also served as an opportunity to refute the basic premise or reasoning behind the establishment of the Inquiry. No such submission was received.

The closing date for submissions was 2 November 2012, however a large number of late submissions were accepted and considered.

A total of 56 submissions to the Inquiry's Discussion and Issues Paper 2012 were received.

Meetings

As part of its work the Inquiry co-ordinated meetings with industry stakeholders as well as solicitors and barristers specialising in construction and trust law, union representatives, engineers, adjudicators, retired judges, accountants and insolvency specialists and representatives from the banking and insurance sectors. These meetings commenced on day two of the Inquiry. A series of teleconferences with senior legal practitioners provided the Inquiry with valuable insight into the American and Canadian experiences of construction trusts and other mechanisms that have existed in many states and provinces in those countries for a considerable period of time. Numerous meetings were held with contractors of varying size and specialisation.

The Inquiry met with subcontractors to hear directly about their experience of debts and losses incurred as a result of the insolvency of head contractors, as well as payment practices within the industry and their views on the effectiveness and practicality of the proposed reform options. A number of case studies have been included in the appendices section of this Report.

On 11 October 2012, the Chair addressed a meeting of builders, lawyers and insolvency experts to discuss the impending release of the Inquiry's Discussion and Issues Paper 2012 and the work of the Inquiry.

The Inquiry met with secretariat representatives of the Council of Australian Government's Review Panel on Construction Costs and Productivity on 25 October 2012 to discuss the work of the Inquiry to date. Representatives from the secretariat confirmed that the Review Panel had not yet been formed.

A total of 130 meetings and teleconferences were held between 14 August and 21 November 2012.

Website

The Inquiry established a website through the NSW Government 'Have Your Say' portal, providing an opportunity for parties to access all relevant information and documents relating to the work of the Inquiry. Parties could also lodge submissions electronically through the website and e-mail Inquiry staff directly. Phone numbers and other contact details for the Inquiry were provided in advertisements to ensure appropriate access for any interested parties.

Surveys

The Inquiry wrote directly to more than 500 contractors, subcontractors and insolvency practitioners working in NSW to alert them to the work of the Inquiry and seeking their assistance by completing enclosed surveys. The survey templates are included in the appendices section of this Report.

Research – local and international

The Inquiry has spent considerable time in researching material relating to the:

- UK, American and Canadian experiences of construction trusts and other formal mechanisms to protect subcontractors interests that operate in those countries; and
- the position in the other Australian States and Territories.

The Inquiry was fortunate to have access to the services of the Crown Solicitor's Office Library, whose staff assisted in sourcing a great deal of valuable legal and other texts for the Inquiry.

A full bibliography has been included in the appendices to this Report.

Industry Reference Group

The Terms of Reference provided for the establishment of an Industry Reference Group comprising of key industry associations and the Small Business Commissioner. The group met three times and were engaged to provide input into the formulation of the Inquiry's Discussion and Issues Paper 2012.

Membership of the reference group has been included in the appendices section of this Report.

NSW Small Business Commissioner

The NSW Small Business Commissioner is a member of the NSW Government Taskforce and a member of the Industry Reference Group. The Commissioner provided the Inquiry with contacts for a number of subcontractors that have recently been affected by the insolvency of a head contractor. The Commissioner also made a formal submission to the Inquiry which was published on the NSW Small Business website at <http://www.smallbusiness.nsw.gov.au>

The role of the Commonwealth

Term of Reference 3(a) obliges the Inquiry to consider the option of improving the priority given to unsecured creditors where the debt results from a subcontracting relationship, while Term of Reference 4 asks the Inquiry in considering recommendations to consider the impact of Commonwealth jurisdiction over insolvency.

The Inquiry does not favour the idea of amending the *Corporations Act 2001* (Cth) so as to give unpaid subcontractors a preferred position in the ranks of creditors in the event of insolvency. The Inquiry did not receive any submissions that set out a convincing case as to why this should feature in the recommendations to Government. In fact, many submissions instead supported the Inquiry's position, arguing that action should be focussed on addressing the underlying factors that lead to insolvency and protecting moneys owed to subcontractors.

The Inquiry has recommended a number of reforms for the purpose of protecting subcontractors that directly address the issue of cash flow in the industry and the protection of payments that are destined for subcontractors. These reforms, if combined with a priority status under the *Corporations Act*, would represent an imbalance of measures to the benefit of subcontractors, not extended to other entities operating in other sectors of the community and economy that of course can also be affected by insolvency.

The Inquiry is however of the view that the Commonwealth is in a position to more effectively address issues relating to the duties of company directors and officers under the *Corporations Act*. Among other duties, the Act sets out the obligation on company directors to prevent insolvent trading and establishes the rights and responsibilities of the parties involved in the business operations of an insolvent company including directors, shareholders, employees and creditors.

The principal regulatory agency responsible for the enforcement of the insolvency provisions of the *Corporations Act* is the Australian Securities and Investment Commission (ASIC).

The Inquiry heard from a senior partner of a top tier insolvency and advisory firm about companies that continue to trade in the face of all available evidence (which may include non-payment of superannuation, workers compensation premiums, late payment to creditors) that shows that that it is unable to pay its debts. He said simply that:

“it’s called insolvent trading and the damage gets greater and greater the longer they trade.”⁴⁵

The Inquiry sees this comment as a confirmation of the dual approach needed to adequately address the issues set out in the Terms of Reference. The existing laws relating to insolvent trading must be enforced. Time and time again, the Inquiry heard from contractors and subcontractors working in the industry that they were aware of the financial troubles and the inevitability of insolvency of particular building companies.

However there were many competent and experienced contractors and subcontractors alike that took the gamble that they would be paid. It is not simply the naïve or inexperienced participants that get caught. A troubling example involved an electrical subcontractor involved in a dispute with Reed Constructions Australia Pty Ltd. After paying a total of \$24,000 to an adjudicator to prepare a security of payments claim for \$1 million and having the adjudicator find in his favour, this electrical subcontractor said the company refused to pay and said “*see you in the Supreme Court*”. This contractor told the Inquiry that he was:

“.....a member of the Australian Institute of Management, an experienced electrical consultant, electrical contractor and have worked in the industry since 1965. I did everything by the book and was always careful who I worked for. If this can happen to me, what about those just starting out?”⁴⁶

Chasing cash flow to survive has meant that a great number of subcontractors in this industry have taken on risk and work that perhaps during a more favourable economic climate with more available work, they simply would have refused or not tendered on. The other part of the dual approach are the Inquiry’s recommendations for reform that go directly to enhancing

⁴⁵ Witness to the Inquiry.

⁴⁶ Witness to the Inquiry.

cash flow, protection of payments to subcontractors and a comprehensive education strategy aimed at subcontractors.

Australian Securities and Investment Commission

During the period 2005/06 to 2009/10, ASIC implemented the National Insolvent Trading Program. The key objective of the program was:

*“....to encourage directors to seek professional advice at an early stage to address their company’s solvency issues, or increase the likelihood of a return to creditors should the company enter into external administration”.*⁴⁷

Under the program, ASIC identified companies through sources such as complaints received from the public, credit agencies, auditor notifications under section 311 of the *Corporations Act*, financial accounts lodged with ASIC and other sources such as lawyers, accountants, insolvency practitioners and the media.

If a preliminary review of a company identified possible insolvency indicators, ASIC would arrange a meeting with the company director(s) and serve a notice to produce relevant records and financial information. Following that meeting, ASIC would undertake a detailed review and analysis of the company books and records. Through the program, ASIC identified a number of indicators of potential insolvency including:

- The company has a history of trading losses;
- The company is experiencing cash flow issues;
- Creditors are not being paid on agreed trading terms;
- The company is not paying its Commonwealth and/or State taxes;
- The company is unable to produce timely accurate financial information; and
- There appears to be no assets that can be sold to help meet debts owed.

Despite inquiries made to ASIC, the Inquiry is not aware of the reasons why the program ceased to operate nor if the agency has established other programs with similar aims. The Inquiry considers that there is merit in re-establishing the program with a focus on the building and construction industry – an industry which ASIC’s own data confirms, continues to be home to more insolvencies than in any other single sector.

In its own report, ASIC considered that the program achieved positive results including:

- Further finance or equity being injected into the company to improve the financial position;
- A restructuring of the business to improve cash flow and overall profitability; and
- Companies seeking professional advice to address solvency concerns.⁴⁸

⁴⁷ ASIC, *National Insolvent Trading Program Report*, October 2010, p.4, para 1.

⁴⁸ *Ibid*, p. 8, para 19.

A proactive approach may achieve two important results. Firstly, the preventing of companies going into administration and possibly liquidation, and secondly, the limiting of the damage and losses that can occur, when an insolvent company continues to trade and pulls others into the debt and loss vortex.

The following quote from a submission to the Inquiry was directed at the Term of Reference relating to consideration of a mandatory insurance scheme:

“Regular solvency checks must be provided at all levels of operation. However, if ASIC and government regulators were tougher on insolvencies, Directors and dummy Directors, then the industry wouldn’t need such an insurance scheme, at a time when projects cannot carry further burden against feasibility.”⁴⁹

The Inquiry considers that much more could be done by ASIC to check the health of businesses in the construction industry.

Phoenixing

A number of stakeholders raised the issue of phoenixing with the Inquiry and their view that this activity was widespread in the building industry and that it was having a significant and lasting detrimental effect on their businesses. In 2011, PricewaterhouseCoopers (PwC) was engaged by the federal Fair Work Ombudsman (FWO) to report on the impact of phoenix activities on the national workplace relations system. The FWO had commissioned the report in response to an increasing trend in phoenixing.

The common view expressed to the Inquiry is summed up in the definition of phoenixing provided in the PwC Phoenix Activity Report. It defined “phoenix activity” as:

“.....the deliberate and systematic liquidation of a corporate trading entity which occurs with the fraudulent or illegal intention to:

- avoid tax and other liabilities, such as employee entitlements; and*
- continue the operation and profit taking of the business through another trading entity.”⁵⁰*

The frustration and anger expressed to the Inquiry at the impugntiy of unscrupulous operators was palpable. Not only could the worst offenders in the industry simply close up shop one day, leaving any number and amount of debts unpaid, and opening up the next day under a different trading name, these were the same operators who were gaining an unfair competitive advantage by undercutting their rivals in the bid process.

⁴⁹ Witness to the Inquiry.

⁵⁰ Pricewaterhouse Coopers, “Phoenix activity, sizing the problem and matching solutions”, Report to the Fair Work Ombudsman, June 2012, p. ii.

The PwC Report estimates the overall cost impact of phoenixing at between \$1.78 billion and \$3.19 billion.⁵¹

Surely there is more work in this area to be done by the Australian Tax Office and ASIC to ensure that the honest operators in the industry, that is the overwhelmingly proportion of contractors, subcontractors and suppliers, get a better deal. The flight of the phoenix is prevalent in the building and construction industry in NSW.

NSW Office of State Revenue

The submission from the NSW Office of State Revenue (OSR) confirmed information received by the Inquiry as to one of the earlier indicators of a financially struggling company - the late or non-payment of tax and superannuation. The OSR outlined its work in identifying high risk businesses that in the past have not complied with tax obligations and is able to extract compliance data and other financial information related to these companies and their directors. Since October 2011, a dedicated team within the OSR has identified and registered 224 high risk companies, recovering approximately \$4 million in payroll tax through the process.

As stated in its submission, the information collected by the OSR could greatly assist the NSW Government in its assessment of construction companies tendering for public work.⁵²

NSW Government procurement

The Inquiry received a submission from the NSW Construction Agencies Insolvencies Taskforce which was established in August 2012 to ensure that government construction projects manage the risk of contractor insolvency effectively. In its submission the Taskforce notes the high rate of insolvency in the industry and the Government's concern about:

“.....potential consequences for the public sector construction program and the impact this situation is having on industry, including small business sub-contractors.”⁵³

The Government has requested the Taskforce to:

- *“review financial assessment guidelines used when selecting contractors and the processes used to monitor financial viability during construction;*
- *identify effective contract management strategies which ensure that contractor payment assurances provided to government are accurate; and*
- *consider improvements to construction procurement which will reduce insolvency related risks to the Government and to sub-contractors.”⁵⁴*

⁵¹ Ibid, p. iii.

⁵² NSW Office of State Revenue, Submission to Inquiry, 14 September 2012.

⁵³ NSW Construction Agencies Insolvency Taskforce, Submission dated 14 November 2012, p 3.

⁵⁴ Ibid, p 2.

The full submission of the Taskforce has been included in the appendices section of this Report.

The Taskforce is due to report to the Minister for Finance and Services in February 2013 on these tasks, on improvements that agencies have implemented and on further actions that the Government could take. The Taskforce also has a role of improving communication and coordination across government agencies.

The Inquiry considers that if substantive progress is made on these critical issues, then it is well placed to address the key recommendations made in this Report.

The Taskforce's submission again confirms the importance of getting these reforms right. As noted in this Report, the Taskforce highlights the volume, importance and growth in state infrastructure investment. A more efficient construction industry with fewer insolvencies has obvious benefits to the Government's construction program.

The NSW Commission of Audit

In 2011, the NSW Government established a Commission of Audit to consider and assess the current operation of the NSW Public Sector and make recommendations on how to improve public sector management and governance.

An Independent Advisory Board chaired by David Gonski AC conducted the Expenditure and Management Audit component. The Commission's Final Report was submitted to the NSW Government in May 2012.

In its Final Report, the Commission of Audit set out some of the key challenges of capital procurement in both the private and public sectors that contributes to significant cost increases, delays and disputes. These are:

- *“A shortage of skilled resources;*
- *Inadequate scoping;*
- *Use of inappropriate delivery methods;*
- *Poor risk allocation; and*
- *Unrealistic time and costs objectives”.*⁵⁵

In meetings and through formal submissions, the Inquiry has heard frequently of these same challenges. While the Commission of Audit in its role focussed on the impact of these factors on the return and cost to Government, the Inquiry confirms that the inadequate scoping of projects and the poor risk allocation within a contract can and do have adverse impacts down the contracting chain to subcontractors working on either Government or private sector construction projects. The Blake Dawson Waldron *Scope for Improvement:*

⁵⁵ NSW Commission of Audit (Chair David Gonski, AC), Final Report: Government Expenditure, 4 May 2012, p. 307.

Project risk-Getting the right balance and outcomes 2011 Report provides a good summary of the issues relating to the identification, management and application of risk in the construction industry.

Among the 132 recommendations made by the Commission of Audit, were suggested changes to the manner, form and ongoing management of procurement within the public sector including expenditure related to capital projects. It is encouraging that the Government has accepted each of the Commission's recommendations as they relate to procurement. Recommendation 116 of the Commission of Audit was that:

"...procurement staff in agencies review and consider the detailed scope of their capital projects before committing to a contract....."

*In supporting this particular recommendation, the Government noted thatachievement in improvement against current performance levels will require an audit of capabilities, addressing the gaps in capability, and a strengthening of controls on capital investment decisions at approval stage and through the life of the project.*⁵⁶

The Inquiry considers this important work that can contribute in a significant way to the tightening up of financial risk assessments utilised by Government agencies in the tender process and during the life of the contract.

Range and scope of government work in the building and construction industry – the need to consider government as client

While it is neither reasonable or factually correct to consider government to be the cause or reason for any insolvencies that occur in the construction industry, it is important to note that as the top link in the contracting chain for work that it commissions, the behaviour of government in tender processes and in its management of contracts cannot be ignored.

If a contractor manages to pass undeservedly through the government financial checks and secures a large government contract and then becomes insolvent, government action has directly contributed to the losses that follow.

The 2003 Cole Report noted that in 2001/02, NSW Government expenditure in the industry represented approximately 25-35 per cent of the total expenditure in the industry in NSW. The 2003 Cole Report stated that the:

*"New South Wales Government is therefore the major client of the industry in the State".*⁵⁷

⁵⁶ NSW Government response to the Final Report of the Commission of Audit, August 2012 p. 79.

⁵⁷ 2003 Cole Report, vol 12, p. 24, para. 38.

The Australian Bureau of Statistics survey of Construction Work Done, Australia shows that across all building work (residential, commercial/non-residential and civil), the NSW Government remains responsible for a very large proportion of construction activity in this state.⁵⁸

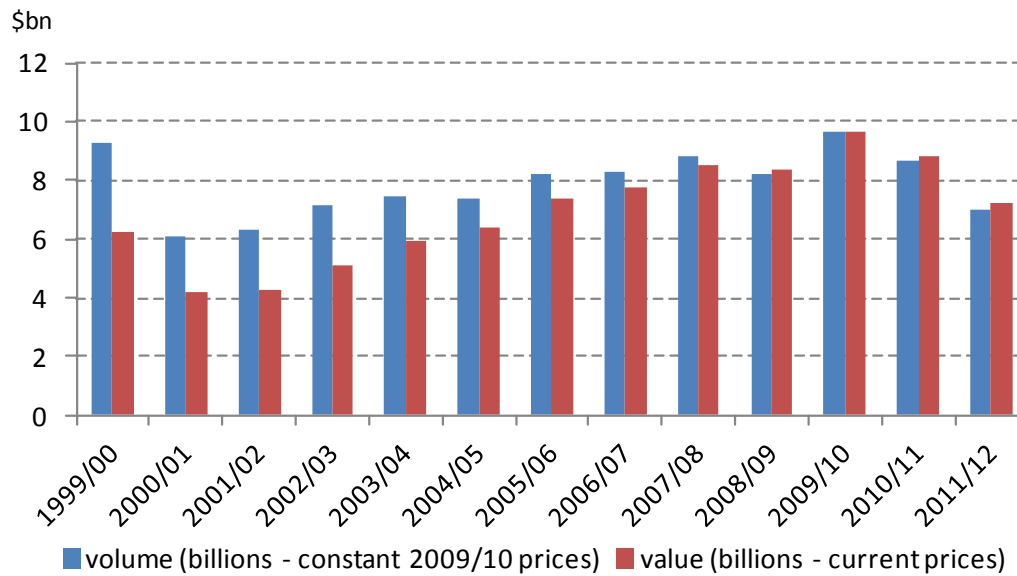
Year	Building and Construction Total Expenditure	Building and Construction Proportion Public
2001/02	18389479	30.2
2002/03	22102118	26.6
2003/04	25496564	23.8
2004/5	27420930	23.9
2005/06	28246085	27.1
2006/07	28291498	28.0
2007/08	30579920	28.0
2008/09	34201487	32.9
2009/10	35772637	40.5
2010/11	38348279	38.5
2011/12	40246480	35.9

The ABS data for residential and non-residential construction work during the 2009/10 and 2010/11 financial years shows the stark effect of the Commonwealth Government's financial stimulus package implemented in response to the Global Financial Crisis. In 2008/09 the residential and non-residential proportion of public expenditure in the construction industry was 2.1 and 19.5 per cent respectively. In 2009/10 this rose to 8.3 per cent in the residential sector and 37.4 per cent for the non-residential sector and in 2010/11 remained high at 7.9 per cent and 32.6 per cent.

In submissions and meetings, the Inquiry has heard of the mixed and often conflicting outcomes of the Commonwealth Government's stimulus program as provided for in the Building the Education Revolution (BER). The Inquiry has heard the generally accepted view that the BER program provided a much needed injection of capital into the industry. However it has also been reported to the Inquiry that for many subcontractors and contractors that picked up business through the BER, the work was outside their usual area of expertise and often of a scope that they had not previously undertaken. This had the effect of stretching many companies beyond what they could ordinarily cope with. Another perverse outcome for many companies that had struggled prior to the injection of government funds in the industry, was the lack of a soft landing once these funds dried up.

⁵⁸ From ABS, Building Activity, Australia (cat. No. 8752.0) and Engineering Construction Activity, Australia (cat. No. 8762.0)

Non-residential construction work done - New South Wales



Source: BIS Shrapnel, ABS 59

The above chart shows non-residential construction work lifted strongly in 2009/10 (+17%) due primarily to a surge in education building related to BER stimulus. After BER funding began to run down in 2010/11, the value of work done has since fallen back, to below pre-GFC levels.

A further observation by many was the ‘overdone’ project management and fees associated with non-building activities, in part symptomatic of the larger and already existing problems in the industry.

⁵⁹ BIS Shrapnel Report, November 2012, p. 3, Chart 3.

The Heart of the Matter

The main body of the Report deals with the following issues:

1. The Terms of Reference with brief annotations
2. Summary findings
3. Retention money
4. Education
5. The statutory construction trust

The Inquiry's conclusions and recommendations then follow.

The Terms of Reference

“The construction industry in NSW has a high rate of insolvency. The industry accounts for fifteen percent of businesses in NSW, but up to thirty percent of the companies going into administration. The government is concerned about this high rate of insolvency and the impact it is having on the community, small businesses, the NSW economy and the government's construction program.”

The government is establishing an independent inquiry to:

1. ***Assess the extent and cause of insolvency in the construction industry.***

The extent of insolvencies in the construction industry has undoubtedly increased. In its report to the Inquiry, BIS Shrapnel stated that:

“Insolvency in NSW construction has accelerated over the past few years.....(and) the industry recorded the highest number of insolvencies of any defined industry for the financial year 2011/12, a total of 1,113 or 24.7% of external administrations reported to ASIC across NSW.”⁶⁰

The summary findings section of this Report provides an examination of the incidence and nature of insolvencies in the industry.

The causes of insolvency are numerous and of course there is almost always a combination of factors that contribute to the collapse of a company without there necessarily being a specific trigger for the event. That is, it would be a rarity to find that one cause is operating to the exclusion of all others or that the effect of a head contractor's insolvency does not have a domino effect on those parties that sit both above and below in the construction chain. The causes of insolvency in the industry are not vastly different to what they were when various different reports also assessed those causes.

⁶⁰ BIS Shrapnel, Report, November 2012, p. 1.

The most common causes cited for insolvency are:

- insufficient capital together with excessive debt;
- poor financial management skills;
- an inability to manage the scope of projects;
- lack of requisite expertise for a particular project;
- low margins;
- payments withheld or not paid;
- fraud;
- poor economic conditions.

This Inquiry has examined the causes of insolvency and has been mindful of the context of the intent of the Terms of Reference, that the focus be at the level of head contractors.

It is noted that there is a lack of information available in the form of hard survey statistics as to where the greater number of insolvencies occur – at the head contractor or subcontractor level.

Nevertheless, one of the most powerful additional causal factors of insolvency applying to the subcontractor, is the insolvency of the head contractor itself.

What has always been uppermost in the Inquiry's thoughts as to the extent of insolvencies, is the significant influence that the prevailing poor economic conditions within the industry have on all participants. This is felt initially though the relatively low levels of work across all sectors that is currently available. In its report to the Inquiry, BIS Shrapnel forecast that NSW construction sector insolvencies will peak in 2012/13.

The Inquiry has found that:

- (i) insolvencies in the building and construction industry are extensive and on the increase;
- (ii) the greatest number of insolvencies in the building and construction sector occur in NSW;
- (iii) the home building sector appears to have a greater proportion of insolvencies than other parts of the industry.

Nevertheless one can prepare for such vicissitudes. For the Inquiry, this places a premium upon immediate action which looks towards a combination of preventative and remedial measures.

2. ***Consider payment practices affecting sub-contractors, existing protections for subcontractors and the impacts of insolvency on sub-contractors.***

Payment practices divide themselves into the world of the highly reputable well run and efficient tiers of contractors in the industry and 'the others'. Efficiency and

reputation is built, partly upon close and effective working relationships with subcontractors which are in their nature repetitive. An effective working relationship viewed by the subcontractor and head contractor must entail reliable, on time payments in exchange for on time work performed to the standard required under the contract.

However what is of greater concern to the Inquiry are the other participants in the industry who are sailing closer to the rocks.

That is not to say though that large, long established building companies are by any means immune from the troubles of insolvency. Indeed, two years after celebrating its 100th anniversary, the collapse of Kell & Rigby, one of Sydney's oldest family owned building companies, is a testament to this. If one goes into the recent past the list becomes much longer.

The Inquiry has been left with a considerable disquiet, for while in a forensic sense it cannot make a finding that numerous contractors are trading while insolvent, nevertheless, it has the distinct feeling that this is the case. Several well informed and experienced industry witnesses said that they were sure that that was the case.

That in turn produces a feeling of disquiet whenever too much is made of cash flow and when cash flow is given its own peculiar meaning in the building and construction industry. In the view of the Inquiry it would be dangerous to allow incantations about the need for cash flow to mask the imminent danger of insolvency.

Remembering that there was a total of 1,113 insolvencies in the NSW construction industry in 2011/12, the following list is a quick sample of companies that have recently failed or gone into voluntary administration:

- Holmwood Builders Pty Ltd (Voluntary Administrator appointed November, 2012)
- Kell & Rigby Investment Holdings Pty Ltd (Liquidator appointed April 2012)
- Southern Cross Constructions (NSW) Pty Ltd (Voluntary Administrator appointed October 2012)
- Reed Constructions Australia Pty Ltd (Liquidator appointed October 2012)
- St Hillier's Construction Pty Ltd (Voluntary Administrator appointed May 2012)
- Perle Pty Ltd (Liquidator appointed February 2011)
- Nahas Constructions (NSW) Pty Ltd (Voluntary Administrator appointed August 2012)
- Bluestone Construction Group Pty Ltd (Voluntary Administrator appointed August 2012)

Current payment practices

The Inquiry has received a great deal of evidence as to the payment practices affecting subcontractors. The evidence has revealed:

- (i) In the modern world of building and construction, approximately 80% of the amount of money claimed in a builder's progress payment will be claimed as a result of work carried out by one or more subcontractors and suppliers.
- (ii) Subcontractor payment cycles are unacceptably long. The due date for progress payments for subcontractors can range anywhere from 14 to 80 days, with the average payment term falling somewhere between 45 to 60 days.
- (iii) It is common practice that payments are late, delayed or reduced to the detriment of subcontractors (and in some cases the head contractor).

These factors are all placing increased pressures upon contractors and subcontractors alike and shifting risk down the contracting chain, contributing to the financial stress of subcontractors and increasing the risk of insolvency.

With this in mind, the Inquiry has recommended the introduction of prompt payment provisions into SOPA.

Any provision in a building and/or construction contract which purported to go beyond the maximum payment terms set out in those recommendations shall by virtue of a recommended amendment to the SOPA, be void and of no effect.

Further, it is recommended that failure to comply with the provisions relating to prompt payment is an offence and will result in penalty rates of interests being paid by the contractor or the owner as the case may be.

Existing protections for subcontractors

The Inquiry has examined a number of mechanisms available to assist in regulating and protecting subcontractor payments, the most notable of these being SOPA. There are also agreed contractual terms setting out dispute resolution mechanisms and remedies under the general law. These are addressed in the Inquiry's summary findings. Broadly speaking the word "protection" is a misnomer.

When examined in the context of the relative bargaining strength of the subcontractor, what has become obvious to the Inquiry is that for many subcontractors the reality is that the existing remedial measures for securing payment are not totally effective, and are often inaccessible, costly and artificial. For all intents and purposes they offer a false sense of "security of payment".

The Inquiry emphasises the point that none of these existing remedial rights and mechanisms operate as a protective mechanism – that is, in "protecting" a subcontractor's payment in the event of a head contractor's insolvency.

It is to that end that the Inquiry's work under Term of Reference 3 begins.

Impact of insolvency on subcontractors

Time and time again, the Inquiry has heard of examples of the devastating impact insolvencies have had on subcontractors – financially, professionally and personally. The faces of those who have voluntarily come before the Inquiry, made submissions and the stories and case studies included in this Report leave no doubt as to the severity of this impact.

3. *Consider legislative or other policy responses that can be taken to minimise the incidence and impact of insolvency in the industry, including:*

Of all the Inquiry's proposed recommendations, the most important of these is the establishment of the Building and Construction Commission. This is discussed in detail in a later section of this Report.

a. options for improving the priority given to unsecured creditors where the debt results from a sub-contracting relationship

For the reasons set out in the Inquiry's Discussion and Issues Paper 2012, the Inquiry remains of the view that the *Corporations Act 2001* (Cth) should *not* be amended so as to give unpaid subcontractors a preferred position in the ranks of creditors in the event of the insolvency of a head contractor.

b. opportunities to simplify debt collection processes

For a small business in the construction industry, the cost of recovering debts and the longer that those debts remain outstanding, the greater the financial hardship felt by that business. The Inquiry has identified a number of opportunities to simplify debt collection procedures. The first of those is to improve dispute resolution mechanisms which may be done in the following five ways:

- (1) by invoking the existing SOPA requirements.
- (2) setting up a statutory compulsory prompt payment regime applying to the principal and the head contractor.
- (3) having retentions held in trust accounts with disputes to be settled rapidly through SOPA.⁶¹
- (4) disputes concerning bank guarantees to be settled through SOPA.
- (5) progress moneys to be paid directly into trust accounts with disputes settled rapidly through SOPA.
- (6) moneys paid out rapidly.

The Inquiry made contact with the Department of Attorney General and Justice to ascertain the status of a review into the debt recovery processes in NSW jointly undertaken with the Better Regulation Office. That review was to consider the effectiveness and efficiency of existing mechanisms and the cost and complexity of current processes. It is understood that the Government is

⁶¹ Presuming of course, the right to approach the Court for injunctive relief to restrain wrongful encroachment.

considering the final report of the 2010 review. This process should continue as part of the remit of the Building and Construction Commission.

c. strategies to improve financial management skills in the industry

This Report examines the typically unequal bargaining power between head contractors and subcontractors. The education program recommended by the Inquiry is seen as a one of a number of critical elements and reforms that seek to address that imbalance.

Education Program

For this reason, the Inquiry has spent considerable time looking at the development and implementation of a readily accessible education program available to subcontractors and others in the building and construction industry. The Inquiry's recommendation on education and training provides considerable detail on the critical elements of an education and training framework for subcontractors.

Critical to the success of this education campaign will be the co-operative and collaborative work to be undertaken by those most able and experienced to do so – the Master Builders Association, the Housing Industry Association and the NSW Small Business Commissioner. The Chartered Institute of Arbitrators and the Institute of Arbitrators and Mediators Australia should also be closely involved in this scheme.

Without being too prescriptive in its recommendations, the Inquiry suggests that based on the evidence it has heard and received, any education initiative ought to include courses to cover the following subjects:

- (i) legislative awareness;
- (ii) financial skills, accounting and bookkeeping, awareness of tax obligations;
- (iii) building and construction contracts;
- (iv) the pricing and management of risks;
- (v) SOPA;
- (vi) enforcing debt payments; and
- (vii) legal fundamentals (including contract law).

d. a mandatory insurance scheme to secure payments to sub-contractors

The views of the insurance industry were considered by the Inquiry through the Insurance Council of Australia's (ICA) membership of the Inquiry's Industry Reference Group, together with meetings with representatives of a number of insurance companies. Trade credit insurance and performance bonds were the subjects of discussion with local industry participants and also practitioners in the US and Canada, where the use of such products is more common. The position of the ICA on mandatory insurance as set out in its submission to the

Inquiry is uncontroversial and is in the Inquiry's view, a true reflection of the position held by most in the industry:

*"We believe there is no appetite among our members for such a statutory scheme where the transfer of risk is unable to be appropriately limited for commercially acceptable rates. In these circumstances the ICA submits that a mandatory insurance scheme is unlikely to achieve the aims set out in the Inquiry's Terms of Reference."*⁶²

Nor is there any real interest in such a scheme from the subcontractors' viewpoint. The Inquiry's Discussion and Issues Paper 2012 highlighted the availability of trade credit insurance and its usefulness in managing the risks associated with payment default and debts arising from the insolvency of debtors. Trade credit insurance, and more generally the purchase and use of financial and other easily accessible information on businesses with whom subcontractors are considering entering into a contract with, are important considerations in mitigating risk in the industry, yet there are no substantive responses to the exposure of these subjects in the Inquiry's Discussion and Issues Paper 2012.

The Inquiry firmly believes however, that any mandatory insurance scheme that operates to secure payments to subcontractors does not directly address the issues at hand. Insurance provides little or no incentive to avoid behaviour that could bring about insolvency or financial stress and could in fact provide a perverse incentive for some subcontractors to take disproportionate risks, knowing that should their businesses fail, they will not bear personal responsibility for the repayment of their debts. The insurance company picks up the tab and the construction industry pays the price.

In any event, there is no information available that suggests that the cost of administering such a potentially expensive scheme would be less than the cost of insolvencies in the sector. There are better ways of achieving the desired result. These are set out in the Report.

- e. *a discretionary mutual fund to compensate contractors from losses arising from insolvency of a lead contractor or principal*

A discretionary mutual fund could be designed to provide for the payment of compensation from a central fund, with contributions coming from one or a combination of government agencies, industry bodies, clients, contractors and/or subcontractors.

Mutual funds however, share the first order weakness attributed to mandatory insurance schemes. That is, such a scheme does not provide a positive incentive

⁶² Insurance Council of Australia, Submission dated 7 November 2012.

for businesses to adapt their behaviour to lessen the likelihood of insolvency. There was no support from industry groups for the establishment of a mutual fund.

f. *the effectiveness of trust arrangements in protecting sub-contractor payments retained by a lead contractor or principal*

Readers of this Report will be left in no doubt that an important recommended reform is the *implementation of the statutory construction trust*. A comprehensive legal analysis of the statutory construction trust is a central part of this Report. That section of the Report sets out the key benefits of the proposal in relation to the effective protection of subcontractors' payments in the event of the insolvency of the head contractor, and also responds in detail to a number of unconvincing and vague criticisms that have been made of the proposal by past inquiries and committees.

g. *mechanisms to ensure appropriate and effective financial disclosure between contracting parties, including disclosing payment of sub-contractors*

The Inquiry's Discussion and Issues Paper 2012 highlighted the responsibility that rests upon all parties in the contracting chain to conduct some due diligence test of potential 'partners' in a construction project. There is much that subcontractors can do to ensure that they minimise risks that they may be exposed to in contracting with a head contractor.

The Inquiry is also aware of the need for head contractors to conduct their own checks on the competence and financial strength of those subcontractors they are considering for the work at hand. The insolvency of a company such as Hastie was brought to the attention of the Inquiry by some contractors, and it was noted that this and similar company collapses can have significant and costly impacts on principals and head contractors.

The universally held view in the industry is that the use of statutory declarations to demonstrate that subcontractors have been paid, does no such thing. The discharge of the commitments referred to in the statutory declarations are not enforced, while some head contractors employ persuasive methods to ensure that what is "due and payable" to subcontractors at a certain time under the contract, becomes "due and payable" at some later date so transforming a lie into a convenient truth. The Inquiry in this respect makes the simple but strong point that if real change is to take root, then existing laws need to be better enforced.

As part of a package of reforms, the Inquiry has recommended that SOPA be amended to include a provision that it is essential to provide the statutory declaration and makes it an offence to declare a false oath and for that provision to be enforced by the agency administering that legislation, the proposed Building and Construction Commission. This is more likely to result in action

being taken against those that make false declarations, than having the NSW Police Force being responsible for these matters as is presently the case.

The Inquiry has also heard that there are low levels of compliance with the ‘Subcontractor’s Statement’ which is a document signed by the subcontractor to confirm to the head contractor that it (the subcontractor) has complied with workers compensation, payroll tax and employee remuneration requirements. This statement effectively protects the head contractor from liability from these matters. The Inquiry was told that as is largely the case with statutory declarations, ‘Subcontractors Statements’ are rarely checked and often contain false information.

h. other relevant issues or innovations raised by the Small Business Commissioner or stakeholders.

The Inquiry has maintained an open door policy enabling any interested party or stakeholder to be able to either make a submission or request a meeting. Through these two primary means, all parties could submit their views on the nature and extent of the problems in the industry and also present their ideas and preferences as to what they considered to be the most effective way of addressing those problems.

The NSW Small Business Commissioner through meetings with the Inquiry and in written submissions, has raised a number of issues which the Inquiry has considered carefully. Copies of those submissions are available at <http://www.smallbiz.nsw.gov.au>

4. *In developing recommendations the inquiry should consider the impact of Commonwealth jurisdiction over insolvency.*

As noted in the Inquiry’s Discussion and Issues Paper 2012, the Inquiry is not recommending any proposal which intersects or conflicts with, or requires any consideration of Commonwealth laws.

5. *The inquiry will receive advice from an industry reference group including industry key associations and the Small Business Commissioner.*

The Industry Reference Group was comprised of key representative organisations from across the building and construction industry. The group met three times during the three months that the work of the Inquiry was conducted. Membership of the group is provided in the appendices section of this Report.

The Inquiry has separately met with the NSW Small Business Commissioner on a number of occasions.

The government has established a taskforce to review government procurement and contract administration processes. The inquiry will also consider the work of this taskforce.

The Construction Agencies Insolvency Taskforce (the Taskforce) was established in August 2012 by the NSW Government to ensure that government construction projects manage the risk of contractor insolvency effectively. The Taskforce's submission to the Inquiry has been considered by the Inquiry and has been included in the appendices to this Report.

The Inquiry invited a number of representatives of the Taskforce to discuss their respective agency's tendering and contract management practices. These contributions have been valuable in the Inquiry's consideration of government procurement practices in the construction industry.

Given the role of the Australian Securities and Investment Commission, it is not the role of the inquiry to make findings in relation to particular incidences of company failure. However, examples of failure may inform consideration of policy and legislative options.

The section of the Report entitled "The role of the Commonwealth" sets out the Inquiry's views on the responsibilities of federal government agencies.

References are made throughout this Report and in the Inquiry's Discussion and Issues Paper 2012, to a number of particular insolvencies to draw attention to both the impact of those events and consider ways in which in the future, preventative measures could work to both lessen the impact and reduce the likelihood of insolvencies.

The inquiry will seek submissions from the construction industry, financial professionals, relevant government regulators and the public.

In the three months that the Inquiry has conducted its work, all sectors of the industry have been consulted, engaged and formal submissions and advice sought. In total, the Inquiry received more than 150 written submissions and conducted 130 separate meetings with builders, contractors, the NSW Small Business Commissioner, banks, insurers, solicitors, barristers, liquidators, engineers, accountants, unions and other industrial organisations, and representatives from government regulators.

The inquiry will report within three months of being established.

Done.

Summary Findings

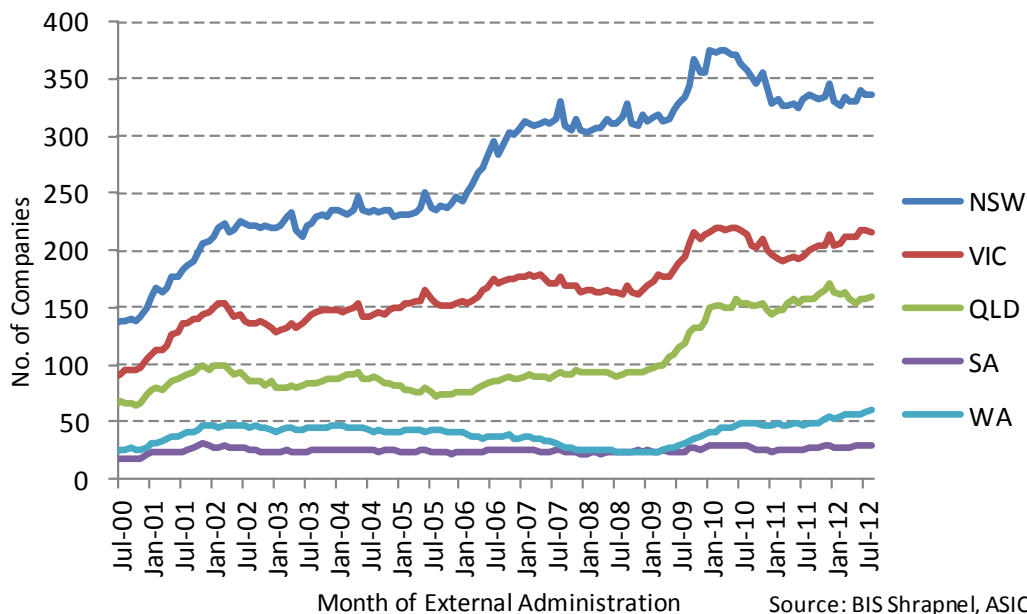
1. The cause, effect and impact of insolvency on subcontractors

ASIC data shows that the rate of insolvency across all Australian States and Territories has been increasing over the last ten years.⁶³ BIS Shrapnel report that:

“The insolvency surge in New South Wales is tending to have a domino effect on many related and unrelated parties. When a mid-sized builder has been placed in administration by its directors, it typically owes money to scores or even several hundred subcontractors and other creditors. Unfortunately the contractors and other parties will often receive little recompense. The insolvent party’s current projects may in some cases be taken on by another firm, but mostly the insolvent party’s creditors will find it hard to receive payments for projects already completed, and this may in turn put those provider businesses themselves at risk.”⁶⁴

The latest statistics from ASIC show that the proportion of initial external administrators reports for companies in NSW fell from 47.7 per cent to 44.7 per cent of reports. However the following chart from the same ASIC report illustrates the stark differences in the incidence of insolvencies across the States and Territories;⁶⁵

Company administrations (ASIC Series 1) - all industries, 12 month rolling average - by state



⁶³ ASIC Australian Insolvency Statistics, Series 1: Companies entering external administration, January 1999-July 2012.

⁶⁴ BIS Shrapnel Report, November 2012, p 6.

⁶⁵ ASIC Report 297, Insolvency Statistics: External administrators reports 1 July 2011-30 June 2012.

⁶⁶ BIS Shrapnel Report, November 2012, p. 7, chart 7.

Typically, basic demographics provides part or more of the answer to questions as to why NSW may appear to be over represented in a data set relating to a particular issue. The above graph shows the proportion of insolvencies in NSW to be almost double that of Victoria, the next most populous State.

Construction companies entering into external administration

The economic conditions prevailing in NSW together with a range of other factors are considered in the analysis of the cause and extent of insolvencies in the construction industry. However in the first instance the continuing disproportionate number of insolvencies in the sector must be acknowledged together with the significant multiplier or knock on effect on other businesses.

In July 1996, Price Waterhouse in its Report for the National Public Works Council identified that:

“the closing down of a business will invariably, directly or indirectly, affect other industry participants further down the contractual chain.”⁶⁷

NSW continues to record the highest number of insolvencies in the construction industry for all jurisdictions. While the proportion of construction industry insolvencies that occur in NSW decreased in the 2011/12 financial year, one in every two insolvency events occurs in NSW.

Financial year	National		NSW		
	Number	Percent of all industries	Number	Percent of all industries (NSW)	Percent of national construction
2004/05	935	20.1	N/A		
2005/06	1177	20.3	N/A		
2006/07	1396	20.3	N/A		
2007/08	1517	21.9	N/A		
2008/09	1760	22.8	N/A		
2009/10	1905	24.1	1031	26.8	54
2010/11	1862	23.1	1006	24.7	54
2011/12	2229	22.1	1112	24.7	50

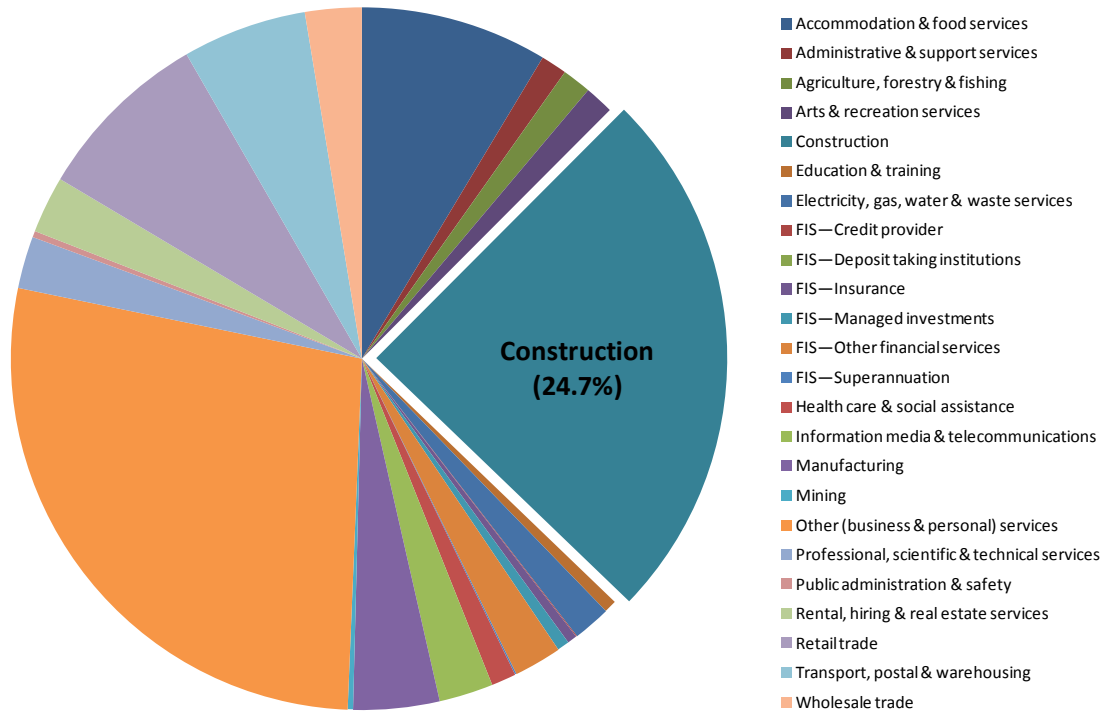
⁶⁸

The following charts clearly illustrate the extent of the problem in the NSW construction industry:

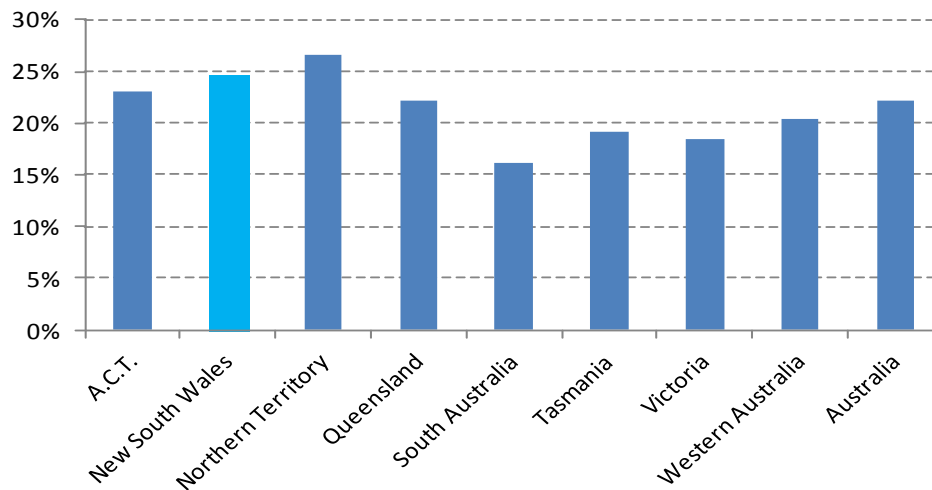
⁶⁷ Price Waterhouse, *Improving Security of Payment in the Building and Construction Industry*, 19 July 1996, commissioned by the National Public Works Council Inc., p. 21 (“1996 Price Waterhouse Report”).

⁶⁸ ASIC Insolvency Statistics.

Insolvencies by industry, 2011/12 – New South Wales



Construction insolvencies as a percent of all industry, 2011/12 – by state



Source: BIS Shrapnel, ASIC 69

⁶⁹ BIS Shrapnel report, November 2012, p. 9, charts 9 and 10.

The ASIC statistics do not distinguish between head contractors and subcontractors that have become insolvent. In more than 75 per cent of insolvencies in the sector, there were either no secured creditors or no moneys owing to secured creditors. The financial loss associated with insolvency is borne overwhelmingly by unsecured creditors – typically the subcontractor. The Inquiry has also heard from suppliers working in the industry and of the losses that they are exposed to in the event of insolvency of a (usually) subcontractor. There is a great deal of merit in considering extending any additional protections that may apply to subcontractors to include suppliers. The Inquiry understands that many suppliers have adjusted the terms under which they provide materials to subcontractors predominately by way of greater up front deposits to reduce this risk. This of course adds further weight to arguments in support of implementing measures that enhance the cash flow for work performed by subcontractors. Suppliers are also able to access the provisions of the *Personal Property and Securities Act 2009* (Cth) and place a charge over materials they supply.

The magnitude of the financial losses facing unsecured creditors in the event of insolvency of a head contractor is documented in the table below.

Estimated debts to unsecured creditors - NSW			
	2009/10	2010/11	2011/12
Company owes less than \$1m			
Number	904	875	938
Estimate of total debt	\$79,684,000	\$69,924,000	\$80,965,000
Company owes \$1m or more			
Number	127	131	175
Estimate of total debt	\$247,000,000	\$269,000,000	\$333,000,000
All companies			
Total number	1031	1006	1113
Estimate of total debt	\$326,684,000	\$338,924,000	\$413,965,000

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As the number of unsecured creditors rises in the three years up to 2011/12, so too does the debt to subcontractors. During this time, 3150 companies going into administration owed unsecured creditors in excess of \$1 billion dollars. These are conservative estimates (see footnote) and it is highly likely that the true amount owing to unsecured creditors is much higher.

⁷⁰ Note – the ASIC statistics separate amounts owed to unsecured creditors into six dollar amount categories: less than \$250,000; \$250,000 - \$500,000; \$500,001 – less than \$1m; \$1m – less than \$5m; \$5m - \$10m; over \$10m. The estimates of total debts in the table above were calculated using the following assumptions – each debt less than \$250,000 was taken to be \$1000 while the amount of each debt in the other amount categories was taken to be the minimum of that category.

No other sector trumps the construction sector for the number of debts owed to unsecured creditors in excess of \$10 million. In the financial year 2011/12, ten companies in the sector collapsed owing unsecured creditors more than \$10 million each.

In a highly competitive industry currently experiencing what many believe to be record low and in many instances, negative margins, any loss of revenue can make it impossible for an entity to continue to trade. Due to the length of the contracting and subcontracting chain in the construction industry, it is the case that insolvency in one part of the chain can inexorably lead to one or more insolvencies further down that chain.

The return to subcontractor

2011/12 ASIC data shows that more than 92 per cent of unsecured creditors in the NSW construction industry, receive zero cents return in the dollar. Just over 5 per cent receive less than 11 cents in the dollar. It was no surprise to the Inquiry to hear that subcontractors and their representatives confirm that they expect and routinely receive nothing or little return in the event of a head contractor becoming insolvent.⁷¹ The experience of many was that chasing the debts owed was more often than not, a case of ‘throwing good money after bad’.

Reasons for failure

The two most common forms of business failure recorded by ASIC are poor strategic management of the business and inadequate cash flow or high cash use. This is consistent across all industries. Poor financial control also ranks highly as a reason for business failure in the construction industry.

There is no question that the current economic conditions have contributed to the number of insolvencies and the likelihood of a contractor or subcontractor going into voluntary administration. The current poor economic conditions in the building industry work to exacerbate the factors that bring many businesses undone. These factors include:

- Insufficient capital and excessive debt;
- Lack of financial skills and management expertise;
- Increase in the scope of the project;
- The business expands too quickly;
- The business expands outside its area of expertise and/or geography; and
- Poor accounting and record keeping practices.

Other factors raised by previous reports, and by witnesses to the Inquiry, included:

- The cyclical nature of the industry;
- Low margins mixed with undercapitalisation and creditor financed growth;

⁷¹ Law Reform Commission of Western Australia, Report of Chairman W.S Martin QC-Project No. 82: *Financial Protection in the Building and Construction Industry* (“1998 WALRC Report”) March 2008, pg. 2

- Payments being withheld as a result of a dispute, financial stress or wilful default by the player;
- Fraud; and
- Disputes.⁷²

All these factors have consistently been raised in submissions to the Inquiry as causes of insolvency. The Inquiry did not hear any specific and direct evidence of fraud which would have enabled it to investigate any particular allegation. References to fraud were loose and general in nature.

The impact of insolvency

On 24 October 2012, at the time of writing this Report, another major building company, Southern Cross Constructions (NSW) Pty Ltd, went into voluntary administration with more than 600 creditors located primarily in NSW. Reports suggest that subcontractors are owed more than \$42 million⁷³ for work performed.

In this latest example as in so many other cases that have been discussed with the Inquiry, it has been claimed that the head contractor had been paid by the client, yet had not passed that money on to its subcontractors. As will be made clear in this Report, in this example, as it is with progress payments right across the building and construction industry, money was paid by the principal predominately *for work performed by the subcontractors*.

While the ASIC data shows the hard numbers, the Inquiry has heard of the financial and social trauma that insolvency inflicts on so many small to medium businesses in the sector. These impacts are illustrated through the case studies that feature in the appendices section of this Report.

Finding

There are a disproportionate number of insolvencies in the construction industry in NSW. These insolvencies have a devastating impact on subcontractors in the industry with amounts left owing to unsecured creditors in the three years up to financial year 2011/12 estimated to be in excess of \$1 billion.

2. Structure of the industry

The Inquiry's Discussion and Issues Paper released October 2012 noted that for the most part, those who are engaged to work on site are typically those entities that have no direct contractual relationship with the client. They are the subcontractors engaged by the head contractor, the sub-subcontractors engaged by subcontractors and so on.

⁷² Queensland Implementation Steering Committee, *Securing our Industry's Future – Report of the Implementation Steering Committee on Security of Payment in the Building and Construction Industry*, October 1997, Queensland Department of Public Works ("1997 Qld Securing Our Industry's Future Report"), p.11.

⁷³ Australian Financial Review, "Southern Cross debt to creditors tops \$42 m", 6 November 2012, p38

The Gyles Royal Commission and the Cole Royal Commission confirmed that the model of construction work began to change in earnest close to 30 years ago. In its submission to the Cole Royal Commission, the Australian Industry Group (AIG) described the contractual process in the industry as:

“....a complex chain of contractual relationships.

Management of a construction project is delegated to a head contractor. Specialist work is then let to subcontractors. However due to issues such as scale and complexity, a significant number of major construction projects have additional layers of contractual relationships.....

[M]ajor construction projects involve a complex sequence of interdependent tasks that require different types of specialist workers. The level and types of specialist skills used, vary over the life of the project.”⁷⁴

There can be little doubt that changes to the structure of the industry that have resulted in often lengthy and complex contracting chains, have contributed in a significant way to the challenges facing the industry. The lack of sophistication of many operators at the subcontracting level of the spectrum, together with their distance from the client/principal and the natural inclination of the head contractor to extract maximum gain from the contract, has resulted in poor outcomes for subcontractors.

Of course the instinct to keep the business afloat through the acceptance of work that leaves no room for profit and simply allows the business to “keep its doors open” in today’s economic climate, exposes these operators to risks that many are simply unable to manage for any sustained period.

The AIG provided the following accurate description of the construction industry:

“Head contractors are not usually the direct employers of the vast majority of labour on a construction project. Head contractors are responsible for the project overall and they typically have a direct contractual relationship with major subcontractors undertaking packages of work. The subcontractors, in turn, have a contractual relationship with sub-subcontractors who perform the bulk of the work on a project.”⁷⁵

ABS statistics show that the construction industry compared to others has by a margin, the most significant proportion of its workforce engaged as contractors.⁷⁶ While this confirms the fundamental change in the structure of the industry, from one in which the building

⁷⁴ 2003 Cole Report, Vol 3, p. 68, para. 57.

⁷⁵ 2003 Cole Report, Vol 3, p. 70, para. 62.

⁷⁶ ABS, Forms of Employment Survey, Australia November 2011, Summary of Findings.

company directly engaged the tradesmen, labourers, architects and so on, to a model best described as project management, it also highlights the vulnerability of many working in the sector, that is, the lack of employment security and access to what most employees regard as obvious and expected benefits such as a weekly or fortnightly pay cheque for subcontractors.

The Inquiry does not seek to make recommendations on changes to the way the industry is structured nor enter the industrial arena where the employee/subcontractor issue continues to be a vexed one and subject to its own reviews and inquiries. What the Inquiry's recommendations work towards is the consideration by Government of policy settings that provide greater security and protection for subcontractors, in an industry that is of fundamental economic importance to the NSW and national economy.

Overwhelmingly small businesses account for the majority of businesses in both the residential and non-residential construction sectors and it has been observed that:

“while having corporate structures, [they] are essentially driven by the personal exertion and labours of the principal tradespeople behind the corporate structure.”⁷⁷

In its 2002/03 Private Sector Construction Survey, the ABS noted that in the residential sector each business had an average workforce of 1.8 persons. On the non-residential side, an average of 4.7 persons were engaged per business. In establishing this Inquiry, the NSW Government has asserted its clear intention to provide better protections for small and medium sized business.

Submissions to the Inquiry

Parties appearing before the Inquiry confirmed what has been accepted as fact for some decades, that is, that the role of head contractors or building companies more generally, is confined primarily to the tender bid process, project management and the use of consultants across the different areas involved in construction. The actual building work across the civil, commercial and to a somewhat lesser extent the residential sector is overwhelmingly performed by subcontractors.

Finding

The majority of construction work in NSW continues to be performed by subcontractors.

3. Payment terms and practices

The key to ensuring subcontractors do not fall into insolvency is understanding that their *“livelihood is dependent on payment.”*⁷⁸ Yet it is clear that save for the unscrupulous, that contractors have *“.....no interest in seeing subbies go broke”*⁷⁹,

⁷⁷ 1996 Price Waterhouse Report, p. 19, at para. 1.5.

⁷⁸ Witness to the Inquiry.

⁷⁹ Witness to the Inquiry.

evidence submitted to the Inquiry shows there are entrenched issues with the industry's payment practices that work to the detriment of the subcontractor. It has been noted by the Inquiry that those subcontractors in the residential building sector generally operate on weekly or fortnightly claims, however for those subcontractors in the commercial sector, claims are almost universally made on a monthly (or longer) basis. It is the case though that some contractors make arrangements to pay subcontractors earlier than the end of the month after a claim was submitted. This could be done where the subcontractor's progress payment was highly labour intensive, the subcontractor was a smaller business⁸⁰ or, as is normally the case, the subcontractor pays its labourers' wages on a weekly basis.

Indicative of the information provided to the Inquiry was this statement from a building and project management company about the "take it leave it" attitude sometimes applied to payments to subcontractors:

"I know personally of one subbie who has worked for a company for 20 plus years occasionally and has always been paid within 7 days. Not long ago he was told that either wait for 30 days or if you want it within 7 days we will deduct 10% from your invoice. How can we allow this to happen?"⁸¹

A number of submissions to the Inquiry suggested that poor payment practices resulted at least in part from ill-advised or unrealistic project expectations and scoping, budgetary constraints, poor planning, poor project/contract management and poor financial control. A poorly scoped project has every chance of developing into a project that suffers from a greater number of disputes and subsequent additional costs.

Self help

The Inquiry's Discussion and Issues Paper 2012 made it clear that there is much that subcontractors should do in order to better protect themselves. Measures range from ensuring that they are themselves equipped with basic financial management and planning skills so as to manage cash flows effectively and with regard to upcoming debts and other obligations, to the basic task of submitting their invoice for payment to the head contractor on time, with sufficient detail to facilitate the efficient processing and payment of that claim. The Inquiry heard from many head contractors and subcontractors about the overall poor standard of record keeping and invoicing that characterises a significant section of the industry. The Inquiry's recommendation on education and training provides detail on the critical elements of an education and training framework for subcontractors.

Based on the information received by the Inquiry, the key issues relating to payment practices can be distilled into the following:

- Onerous payment terms;

⁸⁰ A number of respondents to the Inquiry's subcontractor survey stated that 14 day payment cycles should be used. Some head contractor respondents stated that they would pay their subcontractors earlier than 30 days where the work was labour intensive or they were a smaller business.

⁸¹ Witness to the Inquiry.

- False statutory declarations;
- Head contractors treating money due to subcontractors as their ‘own’; and
- Payments for works and variations being late, delayed, reduced or not paid.

It is instructive to go back to the second reading speech for the introduction of SOPA where the Minister stated:

“Hundreds of subcontractors in New South Wales struggle to survive when they do not receive money owed to them for work undertaken. They do not have the cash flow allowing them to keep on working while waiting for payment. This causes hardship not only to them but also to their families.”⁸²

Falsified statutory declarations

The Inquiry has heard from a number of witnesses about the practice by some head contractors of submitting false statutory declarations to the principal when in fact their subcontractors have not been paid.

The use of statutory declarations in ensuring subcontractors get paid has been described by witnesses to the Inquiry as “mass dishonesty”, “a joke” and that “they appear more comforting than what security they actually provide”. The Inquiry further heard that although it is an offence to swear a false statutory declaration for material benefit under section 25A of the *Oaths Act 1900*,⁸³ punishable by maximum imprisonment for seven years, one of the reasons why the practice is widespread, is that it is not policed.

Evidence was also heard from witnesses of coercion by some head contractors of subcontractors to agree to signing false statutory declarations to say they had been paid on the promise that payment was coming, and that delayed payment on this job was a condition for consideration for any future work.

Head contractors treating subcontractor payments as their own

The Inquiry has heard what appears to be a majority view among the construction community that head contractors treat payments made to them by the principal including payments due to subcontractors as their own money, even when that payment includes substantial amounts due and owing to subcontractors.

⁸² Iemma M, Member for Lakemba and Minister for Public Works and Services and Minister Assisting the Premier on Citizenship. Legislative Assembly, *Second Reading Speech (Hansard), Building and Construction Industry Security of Payment Bill (NSW)*, 29 June 1999.

⁸³ Section 25 provides “any person who wilfully and corruptly makes and subscribes any such declaration, knowing the same to be untrue in any material particular, and who derives or attempts to derive a material benefit as a consequence of the untrue particular is guilty of an offence and is liable on conviction on indictment to imprisonment for a term not exceeding 7 years.”

Currently there are no laws preventing a contractor from utilising money received from principals as they see fit. Evidence has been heard of subcontractor payments being used at one end of the spectrum for discretionary expenditure, while at the other end, the money is used to pay for previous jobs, investments and to finance operational ventures into areas such as residential development. Such practices can put payments due to the subcontractor at considerable risk, particularly in conjunction with poor capitalisation in companies, low margin bidding and poor financial management. On the use by head contractors of money earmarked for subcontractors work, a well respected consulting engineer, adjudicator and arbitrator told the Inquiry that this is:

“an abuse, not a use of cash flow.”⁸⁴

The issue of progress payments will be discussed at length in later sections of this Report, most importantly in connection with the statutory construction trust. It is important to note that under the present law the use of payments made by the client to the head contractor is entirely at the discretion of the head contractor up until the point when moneys become due and payable to the subcontractor for work performed and materials supplied.

The 1996 Price Waterhouse Report made the point that in light of their contribution to the sector, subcontractors have:

“not been sufficiently secured in regards to amounts owing to them for goods and services and material rendered.”⁸⁵

Onerous payment terms

Overall, there appears to be an inconsistency in waiting times before payment is made, with head contractors benefitting from favourable payment cycles under the head contract and in many, but not all cases, imposing longer cycles for its subcontractors.

The Inquiry has heard that many head contractors can have payment cycles with principals of, for example, 30 days after submitting a progress payment claim. In contrast, a number of Inquiry witnesses and submissions have stated that a standard cycle for payment from a head contractor to the subcontractor can be between 45 and 60 days for many builders, quite often as long as 80 days. In its submission to the Inquiry’s Discussion and Issues Paper 2012, the National Electrical and Communications Association, NSW stated that its:

“...members report instances where they have been pushed to accept 45-60 day payment terms. It is common that 45 day payment terms turn into actual payment 60 days and more after the subcontractor has invoiced the Contractor.”⁸⁶

⁸⁴ Witness to the Inquiry.

⁸⁵ 1996 Price Waterhouse Report, p. 21.

⁸⁶ National Electrical Contractors Association NSW, submission p. 3.

The Inquiry's Discussion and Issues Paper 2012 noted that it was not uncommon for subcontractors in the building industry in NSW to wait between 45 and 80 days for payment of their progress claims and that in more recent times, one interstate contractor was insisting that subcontractors sign up to payment terms of 90 days. The Inquiry further heard evidence from one witness that some subcontractors were waiting for up to 120 days before they received payment.⁸⁷

This entrenched delayed payment practice has meant that contractors have a considerably longer period in which to make use of the funds as they see fit before subcontractors are paid, while subcontractors effectively become bankers for long periods of time by providing interest-free credit on labour and materials. Submissions to the Inquiry's Discussion and Issues Paper 2012 confirmed the existence of these practices.

Payments delayed, late, reduced or not paid

Whether late, delayed or reduced, it is clear that the longer subcontractors go without payment for their work and/or materials the greater their risk of falling into insolvency.

The Inquiry has heard from numerous sources about the reasons for payments being late, delayed, reduced or simply not made. Those reasons involving contractors include (though not exhaustively):

- Contractors imposing onerous requirements for the provision of documents when submitting a claim;
- Contractor's holding onto funds for as long as possible by strategically paying some subcontractors who are 'making the most noise' while leaving others unpaid; and
- The adoption in practice of a 'Pay-when-Paid' approach.

In subcontractor survey responses to the Inquiry, it was noted that over half had experienced:

- late, slow, or delayed payment;
- non-payment;
- delays and reductions of variation payments; and
- contract payment cycle periods being increased by the contractor.

The evidence heard by and submitted to the Inquiry on the issue of payments, has exposed the overwhelming view among subcontractors that "there is always a fight for the last payment" at the end of the project.

Some subcontractors spoke of cases where, when the contractor did not make payments, the option to suspend works until payment was forthcoming may be available to them. However the risk to the subcontractor of a contractual dispute being brought on by the head contractor together with the real fear of crueing any possibility of future work, means that more often than not subcontractors were extremely reluctant to withdraw their labour.

⁸⁷ Witness to the Inquiry.

The Inquiry heard on a number of occasions from subcontractors who spoke of their experience with head contractors at the time the last progress payment was due and payable to the subcontractor, where an alleged defects list was produced and the head contractor refused to pay the amount claimed by the subcontractor. One witness who appeared before the Inquiry noted that from his experience in the industry “*contractors welcomed defect lists (from the principal) as it gave them an excuse not to pay subcontractors.*”⁸⁸ This issue was also common to the residential building sector where it appears that some owners on completion of the work, simply refused to pay the builder and invited the builder to sue. This practice was not uncommon in high net worth suburbs with bankers, company executives, lawyers and accountants featuring in complaints. One contractor in the home building sector said that for that reason he would not do any work in the “Northern Beaches area”!

Payment practices between contractors and government principals

The results from the Inquiry’s contractors survey indicated that half of the responding contractors had a negative experience with government payment practices. The reasons given for this included:

- inconsistent payment terms and late payment practices;
- approval, authorisation and sign-off difficulties for payments;
- release of retentions after a project was completed; and
- government budget restrictions.

However, information provided to the Inquiry shows that high end contractors are generally positive about the payment practices with principals (such as Government) and that deviation from scheduled payments being made in accordance with the contract’s terms are usually isolated incidents.

Findings

Subcontractor payment cycles are unacceptably long, and that the common practice is late, delayed or reduced payments to subcontractors (and in some cases the contractor) which are pushing increased financial pressure down the contracting chain and contributing to the financial stress upon subcontractors and increasing the risk of insolvency.

4. Inequality of bargaining power

One need look no further than the vertically aligned structure of the commercial building and construction industry to gain an understanding of the balance of power underpinning it. In a structure that is often described as a “pyramid” or a “chain” with each party representing a link in the chain, it is easy to see why life in business can be difficult for those sitting at the bottom.

⁸⁸ Witness to the Inquiry.

This “pyramid” or “chain” like structure has been documented and described in many of the industry’s reports, discussion papers and journal articles⁸⁹. Of it, legal commentator Teena Zhang makes the following observations:

“A typical construction project is made up of an outward branching tree of relationships with the principal at the very top, connected to the head contractor, with various chains of subcontractors below. Each contributor’s role is important because contracted parties develop relationships of reliance through the need for each to deliver its works to enable others to proceed. It is therefore in the best interests of the project to ensure that each link in the chain is preserved.

One of the most effective ways to facilitate this is by easing the flow of money throughout the construction chain. This preserves the liquidity of contributors to avoid costly replacement and delay. Cash flow is especially pertinent for smaller subcontractors who rely on it to meet debt obligations and keep their businesses solvent. Made vulnerable by their dependence on payment, these subcontractors can be taken advantage of by upstream debtors seeking to increase their margins by deliberately withholding payment in the hope that their creditor will become bankrupt. Recognising that these practices could not be allowed to prevail, governments took action to address the problem.”⁹⁰

The evidence before the Inquiry bears this out.

One witness to the Inquiry on the topic of “Unfair Contractual Terms” shared the following insights:

“The relationship of contract between Contractor and Sub-contractor is often fraught with significant power imbalances. More often than not, the Contractor has greater resources than its Sub-contractors in manpower, money and commercial acumen. Put simply, the relationship is often one of reliance. The Subcontractor relies upon the Contractor for the supply of on-going work. Unless the Sub-contractor is a specialist in its chosen field, it is more likely than not, that if the Sub-contractor

⁸⁹ See, by way of for example, the Cole Report (2003) vol 3, Chapter 2 (Structure of the Industry); Western Australia Law Reform Commission of Western Australia. (March 1998).*Report of Chairman WS Martin QC - Project No 82: Financial Protection in the Building and Construction Industry*, p.3 (para 1.6) and pp. 44-45 (para 3.4); Stenning & Associates Pty Ltd and The Work Lab. *Final Report for the Minister Administering the Building Act 2000 - Security of Payment in the Tasmanian Building and Construction Industry*, 2006, p. 9; Western National Action on Security of Payment in the Construction Industry, APCC, Adelaide 1996, p. 3. Newfoundland Law Reform Commission *Report on the Mechanics' Lien Act: Certain Substantive Issues* 1990, p.1. New Zealand Law Commission Study Paper 3 (NZLC SP3) *Protecting Construction Contractors*, published 1 November 1999, p.4; Collier, Kent W. “The Nuts and Bolts of Bankruptcy, Trust Funds, and the Construction Industry: Building a Solution for Subcontractors Nailed with an Unpaid Bill (2005) 21(2) *Emory Bankruptcy Developments Journal*, 623 at 624; Ettinger, L. P. “Trusts in the Construction Industry” (1988-1989) 27(3) *Alberta Law Review*, p. 391.

⁹⁰ Zhang, T. “Why national legislation is required for the effective operation of the security of payment scheme” (2009) 25 *Building and Construction Law Journal* 376 at 376.

*withdraws its labour or is simply unavailable to perform work for the Contractor, there is a ready supply of alternative Sub-contractors keen for the opportunity to work. This power imbalance more often than not leads to the implementation of contractual terms which significantly favour the Contractor at the expense of the Sub-contractor.*⁹¹

In intensely competitive economic climates such as that in which the building and construction industry finds itself at the moment, this imbalance of power for subcontractors is exacerbated. Many witnesses have informed the Inquiry that in the present somewhat straightened conditions of the industry, the way in which some contractors have sought to remain viable is by “squeezing” the subcontractors - a situation which subcontractors “often feel powerless to complain about because of concern that they will no longer be given work.”⁹² In another submission to the Inquiry this prevailing ‘sport’ has been dubbed the “subbie squeeze”.⁹³

Finally, at the lower tier level (projects less than \$10 million) competition is fierce. The task for the successful tenderer inevitably becomes one of squeezing the lowest price from its subcontractors. The capacity of the builder to extract a lower price from its subcontractor will depend considerably on the economic state of the industry – if the industry is experiencing buoyant times then subcontractors will be less inclined to submit to price pressures from builders. If however, the industry is experiencing tough market conditions, then subcontractors will submit prices with lower profit margins in the hope that this will preserve the ongoing relationships with builders and maintain their volume of work. The view taken is that if they can maintain their work volume, no matter what the profit margin may be, then they may survive the lean period and pursue higher profits when the industry recovers. It is, however, a high risk strategy because any additional pressure (such as late payment) will undermine the subcontractor’s ongoing commercial viability.⁹⁴

The Inquiry has heard and read a large amount of evidence of sad stories of subcontractors suffering severe financial hardship due to the actions of those operating further up the chain. One busy insolvency practitioner who works frequently with financially distressed subcontractors has three other professional business cards on his desk, one a psychiatrist, another a suicide watch organisation and the third a marriage counsellor.⁹⁵ The stories highlight how the inequality of bargaining power for the subcontractor has manifested itself in the following ways:

- practices of delayed payments;
- over-bearing attitudes by head contractors towards subcontractors;
- non-payment or short payment of subcontractors;

⁹¹ Witness to the Inquiry.

⁹² CFMEU (NSW Branch) Construction and General Division, Submission 27 September 2012 p. 5.

⁹³ Witness to the Inquiry.

⁹⁴ Witness to the Inquiry.

⁹⁵ Witness to the Inquiry.

- phoenix company operations of head contractors. Indeed, in one submission to the Inquiry, it was stated that as a “harm minimisation strategy”, contractors were advised to create a separate company for each project and close it down after the completion of the project⁹⁶ (the Inquiry notes that this behaviour is not confined to head contractors).

Whilst it is broadly acknowledged that SOPA has “*changed the balance of power in the way payment claims are managed*”⁹⁷, there remains a general reluctance, particularly on the part of smaller subcontractors to use the SOPA provisions for a variety of reasons.⁹⁸

The Inquiry has heard of unfair and harsh contract terms including set-off provisions, retentions, variations, time bar clauses, termination clauses, penalty clauses and worst of all, the insistence upon long payment cycles.⁹⁹ On the topic of lengthy payment cycles, one industry representative described the construction industry as a “*bottom up funding mechanism*” resulting in a situation where the subcontractor is extending what amounts to an unsecured “*interest-free loan*” to the contractor¹⁰⁰. At the same time, the subcontractor is also paying interest on its overdraft at the bank while it waits for payment from the head contractor.

Risk

“In Lombard Street, published in 1873, Walter Bagehot described with great skill the way in which the City of London had evolved in his time. Bagehot understood that, for all its Darwinian vigour, the British financial system was complex and fragile. ‘In exact proportion to the power of this system’, he observed, ‘is its delicacy – I should hardly say too much if I said its danger...even at the last instant of prosperity, the whole structure is delicate. The peculiar essence of our financial system is an unprecedented trust between man and man; and when that trust is much weakened by hidden causes, a small accident for a moment may almost destroy it.’”¹⁰¹

“We all take risk in business, it is not the Government’s role to eliminate the risk.”¹⁰²

One submission to the Inquiry accurately summed up the knock-on or multiplier effects of the insolvency of one entity in the contracting chain:

⁹⁶ Witness to the Inquiry

⁹⁷ NSW Department of Services, Technology & Administration *NSW Building and Construction Industry Security of Payment Act 1999 & Contractors Debts Act 1997 - Discussion Paper*. Security of Payment Review Team, NSW Department of Services, Technology & Administration. Sydney Australia. September 2010.

⁹⁸ For further details refer to Summary Finding No. 5 in this section of this Report.

⁹⁹ Witnesses to the Inquiry.

¹⁰⁰ Witnesses to the Inquiry.

¹⁰¹ *The Great Degeneration; How Institutions Decay and Economies Die*, Ferguson, Niall, 2012, Allen Lane, Melbourne, p. 70.

¹⁰² Witness to the Inquiry.

“All these networks of interrelated commitments exist ‘below’ the client’s contractual horizon and legislating change to a head contract or a subcontract will not resolve the issue. So it has to be understood that insolvency and collapse within a close network and many smaller operators will directly and indirectly affect upstream and downstream contracts.”¹⁰³

This submission advocates changes to procurement processes, including the manner in which Government tenders its construction work, in order to get to the root cause of the problem. This Report considers the role of Government, including some suggested reforms in another section.

The Blake Dawson Waldron Report *Scope for Improvement 2011* builds on its earlier reports that found scoping practices and risk allocation to be two of the major risk types in construction projects in Australia. The report was informed by surveying industry participants across Australia working on projects with a value in excess of \$20 million. While this scale of project may not be indicative of all sectors within the building and construction industry, some of the recommended treatments of areas for improvement do resonate across the industry. The report notes that those surveyed indicated that there had been some improvement in the identification, allocation and management of risk since the previous surveys (2006 and 2008). However confirming what this Inquiry has heard so often, the report states that contractors are continuing to accept inappropriate risk and that:

“The reason why contractors have had a continued preparedness to accept risk that they cannot effectively or efficiently mitigate or manage appears relatively straight forward. Contractors have a desire, or need, to continue to win work which may have driven them to accept what is proposed by principals.”¹⁰⁴

The Inquiry’s Discussion and Issues Paper 2012 noted the importance of considering the management, allocation, acceptance and avoidance of risk in understanding how the industry operates. At a time where the volume of construction work is depressed and competition for work is highly competitive, participants, particularly subcontractors with fewer resources available to them that may enable them to better identify and price risk, are bidding for and accepting work for which they have inadequately identified and priced the risks.

There are a number of adverse outcomes that arise from this that include the following:

- an inefficient pricing of risk that ultimately inflates the cost of the project;
- a delay in completion of the project; and
- an increase in the number of disputes.

In its submission the Master Plumbers Association of NSW point to the:

¹⁰³ Witness to the Inquiry.

¹⁰⁴ Blake Dawson Waldron, *Scope for Improvement 2011*, p14.

“...ample evidence that poor payment history by a builder may well result in a tender being padded in order to accommodate short term financing costs. This ‘padding’ is required for the additional financing and administration burden placed on the plumber by the poor payment characteristics of the builder. Whilst during the tender phase a builder may have a sound financial backing and status, given that there may be any number of projects underway with the builder at any time the reports are only as good as the financial status on that day. The holding of multiple successful tenders does not guarantee solvency.”¹⁰⁵

A number of submissions to the Inquiry highlighted the need for a greater understanding by head contractors and subcontractors of the tender and contracting processes.

A submission from an electrical contracting company, outlined their main method of avoiding the risk of non-payment of progress and retention moneys – avoid builders! The submission stated that the company:

“...actively seek out jobs and projects where the client is the one paying us ...for two reasons... first is the fear of the builder going broke, not paying us on time, reducing our payments for whatever reason they dream up, placing onerous time frames on the project in order to claim liquidated damages...The second reason we stay away from builders is that they ask at least ten other companies for a quote and they always come back saying you need to lower your price even further if you want the job.”¹⁰⁶

The concept of risk is a fascinating one. It will only be in the theoretical and perfect world that a contractor both properly recognised all of the risks in a job and in fact priced those risks. Speaking to contractors, one is filled with admiration particularly for the good contractors who are capable of recognising the risk, making appropriate provision for it but not pricing the risk. The axiom in the industry is that “if you recognise and priced all of the risks inherent in a job you would never get a single job awarded to you”. So this particular aspect of the Inquiry’s work required it to consider the highly efficient industry which thrives in the city in which talented young lawyers under the supervision of equally talented and experienced partners continue to draft both bespoke and standard form contracts to reflect and accommodate the principal’s position. These contracts become tighter and tighter and more onerous with each succeeding draft. It is fair to say, and it was the subject of a considerable amount of evidence to the Inquiry, that the general impact of this approach is to try to pass as much risk down the line onto the contractors as possible.

It is for reasons of that kind and because of the way in which the Inquiry’s Terms of Reference has been framed, that the Inquiry has also examined the position in the industry from the principal’s point of view.

¹⁰⁵ Master Plumbers Association of NSW, Submission, pp. 5-6.

¹⁰⁶ Witness to the Inquiry.

The disproportionate allocation and transfer of responsibilities, obligations and risks associated with the construction project to those who are least able to handle them – the subcontractor, is a feature of the industry.

In his article “Understanding Risk – The building industry in the 21st Century”¹⁰⁷, the Honourable Terence Cole QC, former Royal Commissioner into the Building and Construction Industry, expounds the importance of understanding and appreciating risk in the building and construction industry. In his opening comments he explains:

*“The greatest threat to your future success in the construction industry is a failure to understand risk. Participants in the industry usually have a low capital base. The use of other people’s capital and assets for project delivery is high. Competition for projects is intense. The profit margin to turnover ratio is comparatively low when compared to other industries with more fixed capital structures. Because the construction of each project is unique, involving a new location, new designs, new personnel, new equipment, new construction conditions, and uncertain weather, the risks involved in a project and its successful delivery are high. Risk is the constant feature of the whole project. And so you must understand it in all its manifestations.”*¹⁰⁸

He then goes on to add:

*“Commercial strength and competitive pressure play a major part in determining which of the parties in the contractual chain ultimately bear the risks to which I have referred. It is not always the party who is most able to control the risk, or which has the financial strength to bear the risk...”*¹⁰⁹

In recent years there have been many endeavours to formulate a different method of risk allocation. The philosophy behind these endeavours has been a recognition that the cascading allocation of risk down to the subcontractor level frequently resulted in risk residing in a party who could do nothing to manage that risk, or who could not sustain its consequences.

¹⁰⁷ Construct For Chartered Building Professionals. The Australian Institute of Building, January 2008 pp.9 -13. (available at <http://www.aib.org.au/lib/pdf/Resources/The%20Hon%20Terence%20Cole%20-%20AIB%20Address%20-%20October%202007.pdf>). In its written submission to this Inquiry dated 1 March 2012, the NSW Business Chamber also highlighted the importance appropriately allocating risk within the government procurement process. At page 2 of its submission, it states (footnotes excluded): “The procurement process also needs to ensure it allocates risk appropriately. This in practice means allocating risk to the party that has control over the risk. Previous procurements have often seen inappropriate risk allocations. A report prepared by Blake Dawson Waldron, *Scope For Improvement 2011: Project Risk – Getting the right balance and outcomes*, found that while approaches to risk for projects are improving, there still remains concerns about how risk is allocated, particularly by contractors. The report found that risk allocation is a significant contributor to delayed completion, cost overruns, reduced quality and disputes. These results can ultimately lead to greater insolvencies, particularly when contractors and sub-contractors have already been tempted to reduce or remove contingency pricing in order to win the contract.”

¹⁰⁸ Ibid p.9.

¹⁰⁹ Ibid p.11.

Indeed, the Inquiry has heard evidence that with the multiple sub-letting of contracts, the subcontractor at the bottom of the chain cannot lawfully meet the requirements of the contract resulting in serious safety breaches, non-payment of workers compensation, government taxes and employee entitlements. Clearly those up the chain profit from such precarious arrangements and happily “*turn a blind eye*”.¹¹⁰

In addition, at a time when contractors and their subcontractors are tendering for and taking on work at, or even below cost, the ability to then price and manage project risks accurately, diminishes considerably as one moves down the contracting chain.

These matters are explored in further detail throughout this Report. Such scenarios, coupled with poor business and management practices, can be fatal to the subcontractor enterprise. The case for a module on risk recognition and assessment in the education curriculum is a strong one.

The Inquiry acknowledges that subcontractors come in all different shapes and sizes and that, in some instances, there are subcontractors who are larger and whose activities have wider reaching impacts than head contractors operating in the industry.¹¹¹ However, on the evidence before the Inquiry, those subcontractors are few and far between and are generally accepted as the ‘exception’.

The Inquiry also acknowledges that irrespective of how far one may go to try and rectify an imbalance of power, there has been and always will be an inequality of bargaining power for subcontractors at some level. Yet it is the view of the Inquiry that any approach taken to improve the position for subcontractors must be accompanied by a resolve on the part of subcontractors to take some initiative and responsibility for their actions. A more aware, informed and better financially educated subcontracting stratum will, to some degree, undoubtedly assist in reducing the incidence and the effects of insolvency.

Finding

That there is a substantial inequality of bargaining power that often operates to the detriment of subcontractors in the building industry.

5. Approach to the NSW Building and Construction Security of Payments

Act 1999

“The modern form of legislation designed to achieve “security of payment” within the building and construction industry was introduced into New South Wales in 1999. The primary aim was to ensure that cash flow was maintained for all participants in the

¹¹⁰ CFMEU (NSW Branch) Submission dated 27 September 2012, p. 3.

¹¹¹ To this point, the Inquiry acknowledges a confidential submission made on the implications to head contractors following the collapse of a large subcontractor.

*contractual chain. A decade later, legislation based upon the New South Wales model is in place in all States and Territories and there is a substantial body of case law governing how the Acts work in practice.....*¹¹²

SOPA has made a significant impact on the legal, structural and cultural landscape underpinning the building and construction industry in NSW.

Where cash flow has been universally acknowledged as the “very lifeblood” of the construction industry,¹¹³ the purpose and objectives for which SOPA, and its equivalent security of payments legislation in other Australian states and territories¹¹⁴, were introduced require no introduction. These have been well identified and documented by many.

In his second reading speech upon the introduction of SOPA, the Hon. Morris Iemma stated:

“Today marks an important occasion for small business and the construction industry. Today also marks an important step in the Government's support of the long fight by subcontractors in the construction industry for justice and security of payment. The Building and Construction Industry Security of Payment Bill is a key component of the Government reform package for security of payment in the New South Wales construction industry. It follows the 15 February announcement by the Premier of the Government's intention to stamp out the un-Australian practice of not paying contractors for work they undertake on construction. It is all too frequently the case that small subcontractors - such as bricklayers, carpenters, electricians and plumbers - are not paid for their work. Many of them cannot survive financially when that occurs, with severe consequences for themselves and their families.

*The Government is determined to rid the construction industry of such totally unacceptable practices.*¹¹⁵

The objectives of SOPA are set out in s. 3(1) of the Act:

3 Object of Act

(1) The object of this Act is to ensure that any person who undertakes to carry out construction work (or who undertakes to supply related goods and services) under a

¹¹² Bell, A. & Vella, D. “From motley patchwork to security blanket: The challenge of national uniformity in Australian “security of payment” legislation” (2010) 84(8) ALJ 565 at 565.

¹¹³ See for example *Dawnays Ltd v FG Minter Ltd and Trollope & Colls Ltd* [1971] 1 WLR 1205 at 1209 per Lord Denning MR; *Modern Engineers (Bristol) Ltd v Gilbert Ash (Northern) Ltd* (1973) 71 LGR 162 at 167 per Lord Denning MR; *Gilbert-Ash (Northern) Ltd v Modern Engineering (Bristol) Ltd* [1973] 3 All ER 195 at 214 per Lord Diplock; *Pegram Shopfitters Ltd v Tally Weijl (UK) Ltd* [2004] 1 W.L.R. 2082 per May LJ at [1].

¹¹⁴ *Building and Construction Industry (Security of Payment) Act 2009* (ACT); *Construction Contracts (Security of Payments) Act 2004* (NT); *Building and Construction Industry Payments Act 2004* (Qld); *Building and Construction Industry Security of Payment Act 2009* (SA); *Building and Construction Industry Security of Payment Act 2009* (TAS); *Building and Construction Industry Security of Payment Act 2002* (Vic); *Construction Contracts Act 2004* (WA).

¹¹⁵ SOPA Bill, Second Reading Speech, Legislative Assembly.

construction contract is entitled to receive, and is able to recover, progress payments in relation to the carrying out of that work and the supplying of those goods and services.

To achieve its aims and objectives, provisions have been introduced into SOPA over the years which have sought to, amongst other things:

- Create statutory rights for claimants such as a right to progress payments (s. 8(1)), a right to interest on late payments (s. 11(2)), a right to suspend work (ss. 15(2), 16(2), 24(1) & 27) and a right of lien (s. 11(3)).
- Outlaw “pay when paid” and “paid if paid” contractual clauses (s. 12(1)) and rendered void contractual provisions which attempt to contract out of the Act (s. 34).
- Introduce a quick and cost-effective process of ‘adjudication’ of disputes over interim progress payments (Part 3, Division 2: ss.17 – 26) which has essentially been described as a “pay now, argue later” scheme. That is, the independent adjudicator makes an interim determination as to the amount of progress payment to be paid to a claimant and, if so determined to be payable, when that payment is to be made (s. 22(1)). The adjudicator’s decision is binding on the parties such that if the adjudicator determines the respondent is required to pay an adjudicated amount, the respondent must pay that amount to the claimant on or before the relevant date (s.23(2)) – that is, “pay now.” That said, the adjudicator’s determination is not final and may, at a later stage, be subject to further dispute between the parties (s. 25(4)) – that is, “argue later.”

A useful summary of this “pay now, argue later” mechanism which has seen a legislative shift in the balance of power between subcontractor and contractor is given by Justice Vickery in *Hickory Developments Pty Ltd v Schiavello (Vic) Pty Ltd & Anor* [2009] VSC 156 at [2]:

“The Act has had a substantial effect in shifting the power balance between principals and subcontractors in construction contracts in Victoria and in other States and Territories where legislation in similar terms and with the same objects has been enacted. Subcontractors are now in a position to promptly secure payments of progress claims with the aid of a statutory mechanism which compliments the provisions of the construction contract. Outstanding claims of the principal under the contract, arising for example from poor workmanship or delay, are preserved as future enforceable claims, but cannot stand in the way of prompt payment of a progress claim found to be due under the expeditious process provided for in the Act.”

- Enable subcontractors to 'leapfrog' up the contractual chain to secure payment by issuing a “payment withholding request” (ss. 26A - 26F). That is, where a subcontractor has made an adjudication application for a progress payment owed by a respondent contractor, the claimant subcontractor can now require a principal

contractor, who owes money to the respondent contractor, to withhold payment of the money owed to that respondent contractor. Contravention of these provisions may render a principal contractor liable for civil penalties.

- Enable subcontractors to obtain from the contractor the name and contact details of any person who is a principal contractor to the contractor (s. 26E).

With the exception of the residential building sector and those construction contracts listed in s. 7 of SOPA, the Act applies to virtually all sectors and echelons within the building and construction industry supplying construction work or related goods and services, including the subcontractors, builders/contractors and owner/principals.¹¹⁶ Whilst the evolution of this legislation has clearly sought to positively change payment practices across the entire construction industry, it is clear that the intended focus of reform has unashamedly been to improve the cash flow for the smaller operators who are at or near the bottom of the contractual chain, by improving payment practices – in essence, the small subcontractors and suppliers who have the least cash flow and struggle to survive when they do not receive money owed to them for the work undertaken.

Is SOPA achieving its objectives, protecting subcontractor payments and reducing the number and severity of insolvencies?

The Inquiry has found that there are disparate views held on the effectiveness of SOPA. Whilst it is beyond the scope of the Terms of Reference of this Inquiry to undertake a comprehensive review of SOPA, it is a necessary and incidental requirement of the Terms of Reference that the Inquiry should make some comment on the many submissions and opinions it has received concerning the effectiveness of the existing SOPA provisions.

For the most part, SOPA has generally been regarded as a valuable system which has brought about an improvement for subcontractors and has gone some way to addressing the imbalance of power between contractor and subcontractor. Indeed, many stakeholders agree that SOPA has made a significant inroad in swinging the legislative pendulum in favour of subcontractors against contractors. Simply put, the general consensus seems to be that “SOPA is working well, but.....”

Notwithstanding this optimistic view, SOPA is not without its faults. SOPA is in need of renovation and there a number of critical elements of the Act which government must address.

The Inquiry has heard and read evidence which has identified a number of criticisms and concerns to suggest that SOPA may not be delivering its desired and intended results. Such criticisms, without specific attribution to any particular individuals or entities, include the following:

¹¹⁶ The Inquiry has been told of many examples of the SOPA provisions being utilised by large contracting firms in disputes with owners.

- SOPA has overseen the development of predatory practices through a “global claims” and “ambit claims” practices approach. That is, some claimants have been seen to be using SOPA in a predatory manner to ambush, surprise or overwhelm respondents. The effect of this has meant that owner and contractor respondents have often been subject to claims which are vague, highly complex, extensive, unreasonable and inflated to include extra issues such as claims relating to breach of contract and damages. These claims have often been “worked up” over extensive periods of time and presented with excessive documentation without warning. Such claims are not commensurate with the original intent of SOPA.
- The short timeframes stipulated in SOPA make it impossible to respond in circumstances where the claims are large and complex (for example, where the contractor saves up the claim and then makes it at the completion of the project which in effect, swamps the principal.) The Inquiry has heard evidence that in some cases, multimillion dollar claims with over 40 boxes of material are essentially ‘dumped’ on respondents who have 10 days to respond.
- SOPA is seen by many who gave evidence as unfairly skewed in favour of the subcontractor claimant in circumstances where:
 - i. claimants can adopt a “global” approach to their claim; and
 - ii. claimants select the adjudicator and forum. This has led to such a pronounced perception of bias toward the subcontractor claimant that it looms as one of the most pressing SOPA issues. More than a dozen witnesses made this point and said that they had lost confidence in SOPA as a result. For example, contractor respondents feel that the adjudication forum is claimant “friendly” and that if a “certain adjudicator is appointed then you are almost guaranteed that the adjudication determination will be pro-subcontractor claimant”. These criticisms, made by senior experienced people, are of great concern to the Inquiry as they have a strong tendency to reduce confidence in legislation which otherwise has merit. Criticisms of this nature were commonly made by highly experienced neutrals with no axe to grind.
- SOPA is “outrageously complicated” and “far too technical”. There are a “labyrinth of procedures” and “even the lawyers struggle” to understand it. Paradoxically, there has been a significant amount of litigation created by a legislative scheme that specifically sought to reduce litigation over progress payments.
- It is extremely costly to run even a simple adjudication claim for \$4,000 to \$5,000. As one subcontractor explains in its submission to the Inquiry:

“The security of payments act is not good enough. It cost about \$2000 for an adjudicator and solicitor fees on top of this can be at least another \$2000. So it is easy for multiple builders to continually underpay contractors by \$4000 or \$5000. That happens to us about 10 times a year. Add to that another \$100K from builders going into administration and we end up making nothing all year.”¹¹⁷

¹¹⁷ Witness to the Inquiry.

- The “biggest weakness” of SOPA is in its enforcement provisions. That is, SOPA does not help in circumstances where the head contractor becomes insolvent. Despite obtaining an adjudication decision, the subcontractor finds it difficult to enforce the judgement and get money from the head contractor.
- It has developed into a “protection tool for the bigger contractors not the ordinary little subbies”.
- Subcontractors at the lower end of the subcontracting stratum are disinclined/reluctant to use the SOPA because:
 - they “don’t understand it” or find it “all too hard”;
 - they are more concerned with getting their next job rather than spending time and money making claims through SOPA; or
 - they fear or have actually been threatened by head contractors that if they do so they will be cut off from future work. The Inquiry has heard that the practice of putting “the magic words at the bottom of the invoice is something that some subcontractors just won’t do as it effects whether they get future work.”
- NSW legislation is out of sync with legislation in other jurisdictions and this may account for the apparent greater difficulty in achieving its outcomes.
- The Victorian and Western Australian Security of Payment Acts contain desirable features which would address some of these complaints.

Most, if not all, of the above criticisms seem to echo those made in previous forums and reviews relating to the operation and effectiveness of SOPA.

Without reproducing an exhaustive list of every other recommendation put forward to this Inquiry, it is worthwhile to list some of the more common proposals. These include (again, without attribution to specific individuals or entities):

- Extending SOPA to apply, in certain circumstances, to the residential/home building sector as is the case in other states such as Queensland. The reason being that all subcontractors should be afforded the same protection.
- Amending SOPA to limit the nature of claims which can be the subject of dispute under SOPA and in consequence, the type and amount of material that can be put before the respondent and adjudicator.

The original intent of SOPA did not extend to complex or highly technical contractual claims and as one stakeholder put it:

“SOPA was not designed as a “cure for badly administered companies” and “was never intended to be a guarantee for payment. The objective of the Act was to enable participants to be paid for the work undertaken.”¹¹⁸

Some have championed the limited claims approach taken by Western Australia in its security of payments legislation.

¹¹⁸ Witness to the Inquiry.

- Amending SOPA to introduce some form of sliding scale with respect to the nature of claims and timeframes for response to claims – the idea being that the larger the claim, the longer the respondent has to respond and the adjudicator has to adjudicate.
- Amending SOPA to remove contractual time bars that seek to defeat claims for payment for works actually performed, but wherein the claimant has failed to comply with the stringent and often complex notice provisions contained in construction contracts.
- Amend SOPA to introduce costs provisions – i.e. introduce a legislative right to recover costs by the successful party.

Other suggested initiatives focus on:

- Educating and improving awareness of SOPA among industry participants.
- Improving the independence and integrity of the adjudication system by reviewing the appointment, education, accreditation, appointment and selection of adjudicators.
- Introducing a national framework for security of payment legislation so that the provisions and implementation are consistent across Australia. Where a significant number of contractors and subcontractors carry out work in states other than NSW, it is arguable that different systems in place in various states can create a burden and barrier to the effective use of this protection mechanism. This sentiment is one which has resounded strongly among many legal writers and commentators of SOPA.¹¹⁹

Of all the recommendations put to this Inquiry, two of the most compelling and which have received almost universal support are:

- Removing the mandatory requirement under s.13(2)(c) of SOPA, that a payment claim must expressly state that it is made under the Act; and
- Setting a statutorily imposed maximum payment term for progress payments due to contractors and subcontractors such that any provision in a building and/or construction contract which purported to go beyond that maximum payment term would be outlawed.

Findings

SOPA, while improving the situation for subcontractors in providing a mechanism for adjudication in disputes relating to progress payments, is in need of a thorough review.

Any challenge to the impartiality of SOPA adjudicators undermines public confidence in an important piece of remedial legislation.

¹¹⁹ See for example: Bell, A. & Vella, D. "From motley patchwork to security blanket: The challenge of national uniformity in Australian "security of payment" legislation" (2010) 84(8) ALJ 565. Davenport, P. "Security of payment now Australia wide" (2010) 131 *Australian Construction Law Newsletter* 36; Zhang, T. "Why national legislation is required for the effective operation of the security of payment scheme" (2009) 25 BCL 376; Coggins, J. Elliott, R. & Bell, M. "'Towards Harmonisation of Construction Industry Payment Legislation: A Consideration of the Success Afforded by the East and West Coast Models in Australia', *Australasian Journal of Construction Economics & Building*, 10(3), pp 14-35.

6. Lack of financial sophistication

The Inquiry provided notice in its Discussion and Issues Paper of its view that participants in the subcontracting sector could in large part, benefit from a greater understanding of financial, taxation, contract management and general business obligations. This is an uncontroversial view. While the same comment may also be applied to some contractors, subcontractors by virtue more often than not, of finding themselves at the bottom of the contracting chain and in a position of a classic price taker (which can change according to the economic conditions of the time), this lack of business and financial acumen hits hard.

There are a number of key elements which must feature in efforts to raise financial awareness and skills of subcontractors. These are:

- Tax and workers compensation premium obligations. The Inquiry heard that the building and construction industry was akin to a “glorified labour exchange” where workers (or subcontractors with an ABN) moved frequently from job to job with different employers. The transient nature of employment within the industry has long been recognised and while the Terms of Reference for this Inquiry do not go to matters of an industrial nature, it is this mobility of workers that (the Inquiry has heard) can often lead to a situation where a subcontractor faces what amounts to a very substantial workers compensation premium that it is unable to pay. While the Inquiry does not share the view outlined in one submission that workers compensation premiums payable by subcontractors should be waived or paid by others, there is a case that may be made as to ensure that the system administered by WorkCover is flexible and recognises the pressures that exist in the industry and the dynamic nature of engagement.

In response to concerns about compliance with tax obligations by contractors in the building and construction industry, the Federal Government announced changes in the 2011/12 budget that require industry participants to disclose all payments that have been made to contractors and subcontractors. These changes commenced 1 July 2012 and are another reason why subcontractors must become better informed;

- Managing the cash flow of the business;
- A better understanding of the tender process and an enhanced ability to identify, price and manage risk;
- A better understanding of existing resources and mechanisms that they can use, eg SOPA.

The Inquiry has received advice from the NSW Small Business Commissioner on a number of issues relating to the capacity and time constraints faced by small business operators. The need for an education campaign together with strategies to improve the level of financial management skills within the industry is dealt with in the recommendations section of this Report.

While it is not true to say that by virtue of its small size, a subcontractor or other business entity is necessarily unsophisticated, the Inquiry is of the view that low barriers to entry into the building and construction industry, particularly in the unlicensed sector of the industry, contribute in no small way to the significant number of enterprises with five or fewer employees that become insolvent.

The ASIC insolvency statistics also show that it is this subset of the industry that is most likely to become insolvent with more than 60 per cent of insolvent companies having five or fewer employees.

It is however interesting to note that the reasons cited as the most frequent causes of insolvency prevail across all the industry groups. They are poor strategic management of the business and inadequate cash flow or high cash use.

The recommendations made by the Inquiry on the issue of education do not imply that there are not some useful tools and information currently available to small business. The Office of the NSW Small Business Commissioner provides a range of information, advisory and advocacy services to small business. The key industry organisations also provide their members with advice and advocacy services. The Master Builders Association recently released its *'Building business start-up kit'* aimed at those who are either looking to start their own business in the construction industry or expand their existing operations.

One submission to the Inquiry noted that all participants:

*"... take risk in business, it is not the Government's role to eliminate the risk."*¹²⁰

The Inquiry is in qualified agreement ¹²¹with this statement and considers the issue of risk in greater detail in another section of this Report. However the implementation of a comprehensive education program and providing meaningful access to it, recognises that many small businesses in this industry simply do not or are unable to allocate the time to get across the issues that may better enable it to meet not only its legal obligations as a business and employer, but also to better understand the terms and conditions of its commercial contracts.

Findings

The subcontracting sector in the construction sector is comprised predominately of small business operators. These businesses are small scale operations that to a very large extent neither seek or are able to afford professional advice on contracting, tax or other business related obligations. A large proportion of the sector lack important yet basic financial management skills

¹²⁰ Witness to the Inquiry.

¹²¹ For obvious reasons, which are set out in the Report, the Inquiry considers that the avoidance of the risk of insolvency and poor judgment and poor payment practices are of considerable interest to government.

7. Use of funds in the payment cycle

“In the construction industry, success comes as a result of your ability to use other people’s money.”¹²²

“There is often more money to be made sticking the money in the bank than the actual job.”¹²³

On commercial construction projects, the terms of payment between a head contractor and subcontractor can range anywhere from between 28 days to the more extreme period of 120 days. The Inquiry has found that the average payment terms between head contractor and subcontractor fall somewhere between 45 to 80 days.

Irrespective of the length of the payment term between a head contractor and its subcontractor, the Inquiry has heard that in any given payment cycle (between principal/owner – head contractor – sub-contractor), there is a window of opportunity for the head contractor to use the progress payments it receives from the owner/principal in an unrestricted manner – that is, as, and however, it so pleases. This opportunity arises from the time between when the head contractor receives a progress payment from the owner/principal (which includes a considerable amount of work done and materials supplied by the subcontractor in the earlier month) to the date when the head contractor pays its subcontractor: this is then aggregated in a pooled account so that quite large amounts of money are involved.

When payment cycles are extended adversely to the subcontractor, the head contractor has the “free use” of those funds, paid to it for the work done and materials supplied by subcontractors and has the opportunity to use or invest the progress payments in any form of investment it likes whether sound, remunerative, hazardous or for purely personal purposes, before payment is otherwise due to its subcontractor.

Curiously, the head contractor’s use of “free capital” within the payment cycle is an aspect of the contract in operation that does not seem to have been earlier canvassed in any detail and surprisingly, was not brought to the forefront of discussions or submissions until the Inquiry began to focus particular attention upon it.

Contractor Cash Flow

It is of some importance to bear in mind the way in which this issue arose in the Inquiry. During the first round of submissions and interviews no contracting company sought to rely upon or to found a criticism upon the effect upon its ability to use the principal’s progress

¹²² Comment made by a senior executive of a large international accounting firm.

¹²³ Comment made by a CEO of a highly respected building company.

payments for any one of what the Inquiry has called the four leaked purposes¹²⁴ outside the project pyramid.

The question of cash flow came up at the commencement of the Inquiry. After raising the issue with a number of witnesses who gave evidence before the Inquiry, a detailed section of the Inquiry's Discussion and Issues Paper 2012 which was described as intended to serve as a lightning rod, was exclusively devoted to the question of cash flow. It is worth bearing in mind the way in which the question was deliberately addressed to the contracting sector of the industry, and set out in the Inquiry's Discussion and Issues Paper 2012 which was broadly disseminated and available online.

The Inquiry's Discussion and Issues Paper 2012 treatment of this issue is of sufficient materiality to warrant repeating in the Final Report. The Inquiry said:

In the course of the Inquiry one of the key questions which has presented itself and which does not appear to have been specifically examined in any detail in earlier inquiries is whether the contractor should be permitted to have a free hand in the investments of those funds during the payment cycle. In particular, if the Inquiry were minded to recommend to the Government that payments to the head contractor by the owner/principal should be impressed with the construction trust, issues arise as to whether there should be some moderation of that position. For example, by the implementation of a statutory provision which authorised the head contractor to invest those funds in similar types of investments provided for in the *NSW Trustee Act 1925* – specifically, those investments listed in the Guidelines for Trustees under clause 4 of the Trustee Regulation 2010, and retain the profits on those investments.

One head contractor has provided the Inquiry with a model for the purpose of demonstrating some of the above information. This model shows that substantial amounts of money in the tens of millions of dollars are at issue.

Questions/Issues for Comment

The Inquiry wishes to be in a position to advise the Government of:

- a) The approximate amount of such funds being invested from time to time during the payment cycle so that the Government may make a clear and helpful appreciation of the effect upon the conduct of business in NSW if there was to be a restriction which clamped the ability of the contractors to use funds in that way.
- b) The nature of such investments and in particular how secure they are.
- c) The terms of such investments whether they are at call or otherwise and so on.
- d) The range of rates of return upon such investments.
- e) How the investments are treated in the accounts of the head contractor.
- f) How important to the financial position of head contractors is the income that is earned from these investments.

¹²⁴ See also the detailed section on the Construction Trust for analysis of the use of funds.

Contractors and other interested parties to whom this Paper has been sent are invited:

- 1) To respond to those matters about which the Inquiry seeks further information in relation to the contractor's use of free capital.
- 2) To comment and critique the commentary in this section and in particular, any issues concerning the payment cycle case example and model provided.
- 3) To prepare and forward their own model of the investment/payment cycle.¹²⁵

Nowhere in the written submissions to the Inquiry were the issues canvassed in the Inquiry's Discussion and Issues Paper 2012, responded to in terms. The Australian Constructors Association wrote that:

*"The ACA does not support the introduction of a construction trust option at this time.....(and).... is unable to respond in detail to the requests for financial information as the information is commercially confidential. If individual contractors wish to provide such information it is a matter for them to decide."*¹²⁶

That is not to slate an unwarranted criticism against those to whom the Inquiry's Discussion and Issues Paper 2012 had been provided. It is, the Inquiry thinks, an indication of the true position that this is not an issue in which the majority of the contracting community had a burning desire to advance at least at that time. From that and from some of the material which appears below, the Inquiry notes that although it is satisfied that it has acquitted itself of what it sees as its duty to plainly flag all of these issues to give every concerned party a full opportunity to deal with the issue, it did receive only one detailed confidential written response to the request for a specific analysis of cash flow.

The Inquiry however took the view that the matter should not end there and continued to investigate the matter through the good offices of a number of accountancy firms who had kindly provided their services to the Inquiry free of charge. A separate section of the Report acknowledges the work of these professionals. The ACA has subsequently advised that it believes further work is necessary to undertake a substantial analysis of the impact of the construction trust.

In addition to speaking to professionals from the accounting and insolvency professions, the Inquiry also requested those professionals to carry out some modelling in order to enable the Inquiry to get some idea of the impact or lack thereof, of the introduction of the construction trust.

The background to this and the context in which these inquiries are set may be found in the comments made by the Honourable TRH Cole QC in the course of his report into the Royal Commission where having observed that *".....industry opposition to trusts is so*

¹²⁵ Inquiry Discussion and Issues Paper 2012, p 42.

¹²⁶ Australian Constructors Association, 5 November 2012, p. 6-7.

*entrenched*¹²⁷ went on to say that no evidence was placed before him of any significant or substantial character in order to enable him to form a view as to whether or not that opposition was well founded. It seems that in the 20 years that has passed nothing has changed in that respect.

In addition to the measures taken by the Inquiry in utilising the services of insolvency and accountancy professionals it was thought prudent to raise the matter with the Australian Bankers Association (ABA). The ABA's response is outlined in the "Statutory Construction Trust" section of this Report.

The Inquiry also questioned a number of contractors and other interested parties directly, concerning the way in which these funds, accumulated from time to time by contractors in the form of progress payments made by owners/principals and which include substantial amounts in respect of work carried out by subcontractors, are dealt with. The Inquiry has heard that funds of this nature are used in a variety of ways which may include the following alternatives (without attribution of the comments to any specific individual or entity):

- a. The funds are used to reimburse the head contractor in circumstances where the head contractor is, in effect, funding itself. For example, where the head contractor has itself been delayed in the receipt of progress payments from the owner/principal and has used alternative funds to ensure that its subcontractor is paid in accordance with the terms of the subcontract.
- b. The funds may be retained in a bank account on commercial rates of interest with the proceeds of the investment retained by the head contractor. As one witness said, the terms of payment are so tight that there is not enough of a lag time between payments from the owner to the head contractor before the head contractor is required to pay the subcontractors.
- c. The funds may be invested in another form other than just a simple bank account. They may be invested in an interest bearing deposit, be put out on the short term money market or invested with other non-bank financial intermediaries.
- d. The funds may be invested in another form of secure or relatively secure investment for a longer term which may take the form of debentures bonds or mortgages.
- e. The funds may be let out at relatively high rates on secured investments.
- f. The funds may be let out on unsecure investment.
- g. The funds may be used to pay debts of the head contractor on the particular job at hand.
- h. The funds may be used to pay off other debts of the head contractor.
- i. The funds may be used to help finance other jobs of the head contractor ("Oil the gate that squeaks the loudest"; "It's like a game of musical chairs"); and
- j. The funds may be spent on discretionary luxury expenditures or unrelated personal purposes outside the contractor business profile, or development ventures in which the contractor is engaged collaterally at the same time as its commercial construction work for an owner/principal.

¹²⁷ 2003 Cole Report, vol. 2, p. 250, para. 109.

There is nothing unlawful or unethical in them selves about each of the “investment” practices outlined above. Nor would the head contractor be in breach of the terms of payment to the subcontractor until after such time as the due date for payment had expired and the subcontractor had not been paid. The terms and conditions of each investment are significant. For example, in the case of money retained in a bank account, the funds may be immediately withdrawn and money in the short-term money market may be withdrawn generally within 24 hours.

In more notorious cases such as those outlined in (f) to (j) above, the Inquiry has heard that where funds are used in these ways there is little hope of seeing them reimbursed and redirected for payment to the subcontractor. Many witnesses have said that in these cases, the head contractor makes the mistake of thinking, in colloquial terms, that the money is “theirs” and that use by head contractors of money earmarked for subcontractors work is “an abuse, not a use of cash flow”. One impressive witness with more than 50 years experience in the industry said that when the payment to the principal to the head contractor is not passed on to the subcontractor “*it is the same as theft*”.

One head contractor company¹²⁸ provided the Inquiry with a model for the purpose of highlighting some of the above information and demonstrating that there is a legitimate opportunity to make money by investing money in the interim. Three important points emerge from this model:

- that a substantial amount of money in the tens of millions of dollars for large contractors is to be made by contractors who legitimately exercise this “treasury” function;
- head contractors who have healthy balance sheets which confirm that they have the capitalisation and are big enough to invest in these legitimate ways are not the ones who are likely to be in default of payment to subcontractors or squander the funds for extraneous purposes; and
- in exercising this “treasury function” the head contractor has a number of safeguards in place including the preparation of detailed monthly cash flows as well as forecast cash flows “to make sure we have enough money for our creditors.” They also arrange such investments on a tiered structure which allows for different terms – for example 1 day, 11 days or up to 6 month tranches (noting that a six month investment tranche would never be required for creditors – this would be a profit only account).

Before this Inquiry, one of the interesting propositions advanced was that the trust arrangement should not be imposed, as in reality, contractors require continued and unrestricted use of progress payments during the payment cycle or they may ‘topple over’.

¹²⁸ The Chair expresses his sincere appreciation to this head contractor company (whose identity will remain anonymous) for the co-operation, assistance, frank disclosures and helpful information provided on this and other related topics relevant to the Inquiry’s Terms of Reference.

Therefore, it has been suggested that if the Inquiry were to recommend the creation of a statutory construction trust then it would be doing a disservice to subcontractors.

To that proposition, the Inquiry sought the views of those in the various American states and Canadian provinces who have in force statutory construction trust provisions. The Inquiry was enlightened by this opinion expressed by Mr Kent Collier, lawyer at Sutherland Asbill & Brennan LLP Atlanta Georgia:

“My impression is that most people in the construction industry realize that money received by an owner is not typically paying for work that the general contractor is actually performing itself. In the United States, most general contractors subcontract out much of the work so the money they are receiving from owners is primarily for the subcontractors. What general contractors are actually being paid for is project management, and relatively small amounts of self-performed work. Most people understand that the general contractor should not be allowed to keep the money owed to subcontractors or make a profit from it but should pass that money promptly down the chain.”¹²⁹

Having heard and considered the views of its international colleagues and of many here in NSW, the Inquiry remains of the view that this reason against recommending the introduction of a statutory construction trust is unmeritorious.

Findings

That the progress payments paid by the client to the head contractor are overwhelmingly for work performed by subcontractors.

8. The Queensland model

The Queensland Building Services Authority (BSA) is a statutory authority established under the *Queensland Building Services Authority Act 1991*. The underlying premise of its establishment was that all Government policy and services in relation to the home building industry (and later commercial building) should be co-ordinated and provided by a single body.

The BSA's charter is to regulate the building industry through the licensing of contractors, educate consumers about their rights and obligations, make contractors aware of their legal rights and responsibilities, handle disputes fairly and equitably, protect consumers against loss through statutory insurance, implement and enforce legislative reforms and where necessary prosecute persons not complying with the law. Of particular interest to the Inquiry and discussed in detail in a later section of this Report, are the financial requirements for licensing that are a vital part of the regulatory framework that work to address the financial

¹²⁹ Inquiry teleconference 11 October 2012 with Mr Kent Collier, lawyer at Sutherland Asbill & Brennan LLP Atlanta Georgia.

capacity of contractors and subcontractors in the sector. It is substantially these requirements, backed by financial audits conducted by the BSA of licensed contractors that provide a safeguard that works to ensure that only those builders with sufficient capital underpinnings are able to work on construction projects of certain monetary amounts.

Legislation Administered by the BSA

- *Building and Construction Industry Payments Act 2004*
- *Building and Construction Industry Payments Regulation 2004*
- *Domestic Building Contracts Act 2000*
- *Domestic Building Contracts Regulation 2010*
- *Queensland Building Services Authority Act 1991*
- *Queensland Building Services Authority Regulation 2003*
- *Subcontractors' Charges Act 1974*

Queensland Building Services Authority Act 1991

The objectives of the Act:

- To regulate the building industry – to ensure maintenance of proper standards in the industry and to achieve a reasonable balance between the interests of building contractors and consumers.
- To provide remedies for defective building work.
- To provide support, education and advice for those undertaking building works and consumers.

BSA Mission and Vision

Mission: To improve standards, equity and confidence in the building industry.

Vision: A highly competent, compliant sustainable and responsive Queensland Building Industry.

BSA Integrated Regulatory Model

Three functional elements of the model – a mutual dependency

Enablers – to maintain the integrity of the model

Licensing

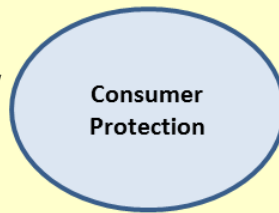
Based on principles of:

- **Consumer information** – a contractor's technical skills, experience and history
- **Maintenance of standards** – a level playing field for all contractors
- **Power to suspend or cancel a license** – to maintain the effectiveness of the licensing system
- **Consumer protection** – to ensure the delivery of a product of a reasonable standard

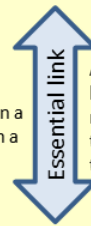
Consumer confidence in engaging a licensed contractor is underpinned by BSA's power to require rectification of defective work.



Efficient and effective dispute resolution is only achievable via integrated licensing and dispute management.



Access to insurance is contingent on a contract with a licensed contractor.

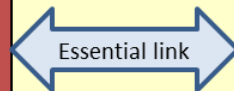


Affordable insurance is based ability for BSA to recover the amount from the licensee and may impact their right to retain license.

Dispute Resolution

A mechanism which:

- **Supports the consumer** – if they are unable to have a licence holder correct defective work; and
- **Balances the rights of the contractor** – via independent review of a consumer complaint (i.e. a site inspection determined defect).



Insurance (home warranty scheme)

A Consumer protection safety net once under a residential building contract covering:

- **During construction** – contractor failure to complete contracted works and/or bankruptcy of the contractors
- **After completion** – failure of contractors to fix defects and effects of subsidence for a maximum period of 6.5 years.

Education
BSA regulation & role must be clear and well understood by both consumers and contractors

Compliance
QBSA Act 1991 and Domestic Building Contracts Act 2000

Contract regulation, legislation and policy setting
Domestic Building Contracts Act 2000

Corporate services

Other influencing legislation, regulations and codes

Funding of the model

The Inquiry understands that issues relating to the cost of establishing and operating an integrated model such as that in Queensland, are important considerations for Government.

The BSA has provided the following information to the Inquiry as to the funding of the integrated model:

“Financial management of the BSA is through two funds, a General Fund and an Insurance Fund. All activities except the compulsory home warranty insurance scheme are administered through the General Fund.

The BSA’s General Fund is funded through the following sources:

- *Licence fees, Building Certifier fees and Owner Builder Permits*
- *Licensee Register and Home Warranty searches*
- *Fines from prosecutions and infringement notices*

The BSA’s General Fund net asset position was \$22.528M at 30 June 2012 and BSA’s Insurance Fund net asset position was \$13.4M.

While the asset positions of both funds fluctuate based on the economic conditions and building activity at the time, BSA’s funds have remained very solid over the many years.”¹³⁰

The 2011 BSA organisation review project

In 2011, the national accounting firm KPMG was engaged by the BSA to review the organisational structure, the external environment and stakeholder perceptions of the effectiveness of the regulator.

Among the key messages gathered during consultation by the Review, was the perspective of the industry associations and builders that the:

*“...stringent financial requirements placed on licensees (while resisted by many licensees when first introduced) contributed to the Queensland construction sector ‘riding out’ the GFC”.*¹³¹

This statement supports the anecdotal evidence supplied to the Inquiry by contractors and subcontractors.

¹³⁰ Advice from BSA, dated 13 November 2012.

¹³¹ KPMG, *Queensland Building Services Authority Organisation Review Project, Final Report 2011*, June 2011 p. 46.

The Review also noted the need for subcontractor accountability and recommended that a model be developed to address this issue.¹³²

Inquiry into the operation and performance of the BSA

The Inquiry notes the ongoing inquiry work of the Queensland Parliament's Transport, Housing and Local Government Committee, that is to report on the operation and performance of the BSA in its regulation of the industry, including the maintenance of proper standards in the industry. Specifically, the Committee is considering:

- whether the performance of the BSA achieves a balance between the interests of building contractors and consumers;
- whether the BSA could make further changes in order to reduce regulations to lower the cost of building a home;
- the effectiveness of the BSA to provide remedies for defective building work and to provide support, education and advice for both those who undertake building work and consumers;
- the governance arrangements of and between the Board and the General Manager;
- the effectiveness of the Queensland Home Warranty Scheme and its protections;
- whether the current licensing requirements of the BSA are adequate and that there is sufficient auditing processes to maintain proper standards;
- the number of trades licensed by the BSA and whether industry groups could take a greater role within BSA in terms of licensing standards and procedures for their members; and
- examining opportunities for reform of the Authority with a view to enhanced assistance for both industry and consumers.

The Queensland Parliament's Inquiry is due to report to Government by 30 November 2012. There may be recommendations arising from this review of the BSA that have relevance to the Terms of Reference for the NSW Inquiry. The Inquiry recommends that the NSW Government consider these recommendations in any deliberations it has on the merits of introducing a system similar to that operating in Queensland.

Findings

That the Queensland model provides an integrated and functional approach to regulating the building industry in that State.

A cost benefit analysis will be the next step in determining whether the Queensland model is in all respects suitable for NSW.

¹³² Ibid, p. 82.

That the licensing of commercial contractors with mandatory financial requirements relating to work of different value and the auditing of these requirements provides substantial protection against insolvency caused by inadequate financial backing and capacity of the contractor.

That the Queensland model has not established barriers to entry that prohibit licensed and suitably qualified trades people from working at the lower value sections of the construction industry and provides earned progression up the ladder for those who deserve such progression.

9. The need for a licensing system in NSW: a puzzling anomaly

The Inquiry's Discussion and Issues Paper 2012 highlighted what it considers to be a significant anomaly. Builders working in the residential building sector are required to be licensed while for those working in the commercial sector there is no such requirement. Licensing as it operates in Queensland under the BSA imposes identified capitalisation requirements in order for the contractor to be eligible to work on projects of a particular value. It is these requirements, together with an appropriate audit regime to check the financial health of the contractor and the accuracy of statements provided to the regulator, that address issues of capability and stressors on a business that can contribute to insolvency. The licensing system is designed to act as a protective measure to all in the contracting chain and a preventative measure against insolvency. These issues are discussed in further detail elsewhere in this Report. The Inquiry notes the view of an accountant working for 29 years in the construction industry:

“Having worked with the Queensland licensing for several years.....I see some advantages with it, firstly from an industry perspective the participants have a very real financial interest in tendering projects at prices that maintain a level of profitability (they do not want to buy projects that affect the equity in the business)there is less volatility in the market.....contractors and subcontractors.....all have similar licensing requirements. The other main advantage of the Queensland model is that is (sic) forces both contractor and subcontractor to maintain both equity and importantly solvency in the business. This assists all contracting parties to cope with any financial shock that may arise..... [the licensing system] also will act as an early warning system when the financial tests are failed and potentially (sic) reduce the exposure to innocent parties.”¹³³

The Inquiry respectfully agrees.

¹³³ Witness to the Inquiry.

Better regulation principles

The Inquiry understands that any regulatory proposal that may result in new or additional costs to business should be assessed according to principles set out by the Better Regulation Office, part of the NSW Department of Premier and Cabinet. This assessment is designed to ensure that on balance, the benefits of a particular regulatory proposal outweigh the costs to business and the community. While it is clear to the Inquiry that the benefits arising from its recommendations should outweigh the costs, that is not a field within the expertise of the Inquiry and it did not hear any expert evidence on the subject. A cost benefit analysis will have to be conducted.

Nevertheless, it is useful to apply, albeit in a slightly condensed fashion, the general test applied to new regulatory proposals. In terms of the evidence of the problem and the benefits to be realised from suggested reforms, the proceeding sections of this Report provide a clear picture as to the nature, extent, age and currency of the problems.

It should also be noted that one or a series of recommendations that concentrate on either one sector of the industry or a particular single behaviour, will prove unlikely to be effective. The recommendations put forward for the Government to consider are a package of reforms that in different ways, work to:

- address the causes of insolvency and thus reduce the incidence of insolvency;
- promote a more informed and knowledgeable industry;
- enhance dispute resolution procedures; and
- protect progress payments and retention moneys owed to subcontractors for the work performed.

Readers of the Report will see reference to the evidence of past inquiries, reports and commissions clearly set out. This evidence and the related findings on the nature and the extent of the problems remain relevant and consistent with the written and verbal submissions made to this Inquiry.

For the purposes of this assessment, the ‘regulation’ is considered to be the package of reforms rather than the individual components.

The Terms of Reference set a task for the Inquiry to consider legislative or other policy responses that can be taken to minimise the incidence and impact of insolvency in the industry. These have included:

- Maintaining the status quo;
- Improving the priority of subcontractors as unsecured creditors under the *Corporations Act 2001*;
- A mandatory insurance scheme to protect subcontractors;

- A discretionary mutual fund to compensate contractors for losses arising from the insolvency of a head contractor or principal;
- The effectiveness of trust arrangements in protecting subcontractor payments retained by a lead contractor or principal; and
- Mechanisms to ensure appropriate and effective financial disclosure between contracting parties, including disclosing payment of subcontractors.

Principle 1: The need for government action should be established. In an earlier section of this Report, the extent of the monetary loss to unsecured creditors was highlighted and it is in excess of \$1 billion over the last three financial years. The numerous case studies from subcontractors that form part of the appendices to this Report also make a clear case for government intervention.

In the financial year 2011/12, 1,113 construction companies went into insolvency in NSW. This figure does not include those entities operating under a non-company structure, for example partnership arrangements. On 24 October 2012, voluntary administrators Cor Cordis Chartered Accountants were appointed for Southern Cross Constructions (NSW) Pty Ltd. The most recent figures of the amount owed to unsecured creditors, that is subcontractors who have performed the work on the ongoing residential, industrial and retail developments, is \$42 million. It is important to note that through the federal government's General Employee Entitlements and Redundancy Scheme (GEERS), the 39 company employees of Southern Cross, have some protection in relation to unpaid employee entitlements through the liquidation of their former employer.¹³⁴ However the close to 600 unsecured creditors owed approximately \$42 million, have no such protection. While this Inquiry does not recommend changes to the priority of unsecured creditors in an insolvency event for reasons set out elsewhere in this Report, the situation where close to 600 invariably small business operators can be left with nothing, which is the typical outcome of an insolvency for these creditors, is simply unacceptable.

As one of the key hubs of employment and economic activity in this and all States and Territories in Australia, the good health and effective operation of the building and construction industry is essential.

The need for government action was established some time ago, and this Inquiry brings fresh evidence and findings to support concerted action being taken by Government.

Principle 2: the objective of government action should be clear. In establishing this Inquiry the overall objective of Government was crystal clear. The primary objective as stated by the Minister for Finance and Services in his media release of 9 August 2012 was to look at:

“...what reforms are needed to minimise the adverse effects on subcontractors.”¹³⁵

¹³⁴ Cor Cordis Chartered Accountants, appointed voluntary administrators, media release 26 October 2012

¹³⁵ Ibid.

In that same media release the Minister also stated that:

“Between 2009 and 2011, hundreds of companies in NSW collapsed owing billions of dollars, slamming the brakes on vital projects and investment.”¹³⁶

The objectives of the reforms recommended by this Inquiry are to ensure better protections for subcontractors, promote greater financial disclosures and transparency between contracting parties and provide for a better regulated, informed and educated industry.

Principle 3: the impact of government action should be properly understood by considering the costs and benefits of a range of options, including non-regulatory options. The Inquiry has considered a broad range of options, both regulatory and non-regulatory, in developing a package of reforms that address the fundamental issues. As part of this work, the Inquiry has engaged leading experts in accounting, insolvency, the construction, banking and insurance industries, to ensure that both the key internal and industry specific factors as well as the environmental factors were appropriately considered and reviewed. The options considered by the Inquiry to better protect subcontractors and improve disclosure and payment practices within the industry were all tested with these experts. The Inquiry’s Industry Reference Group also played an important role in testing the different approaches that Government could take to address the issues.

In relation to licensing, there will always be some who raise the concern that licensing (or other forms of regulation) will work as a barrier to entry and restrict competition within the industry. Rather than operating as a barrier to entry, the Inquiry is of the firm belief that licensing of builders in the commercial sector that has attached to it, requirements for prescribed levels of financial backing and net tangible assets, will work to instil some much needed financial discipline within the industry and leave open to any properly licensed person the ability to work in the industry.

Principle 4: Government action should be effective and proportional. The key recommendations set out by the Inquiry are:

- licensing and appropriate financial backing for builders in the commercial sector;
- legislated prompt payment provisions;
- trust arrangements for progress payments and retention moneys; and
- education.

In relation to the licensing of commercial builders and prompt payment provisions, the majority of States and Territories in Australia acted some time ago to enact these regulatory initiatives in the building industry. There is no evidence that the Inquiry is aware of that has demonstrated that these initiatives are ineffective or out of proportion to the problem that they were designed to address.

¹³⁶ Media Release, Minister for Finance and Services, dated 9 August 2021.

Principle 5 Consultation with business and the community should inform regulatory development. In its three months of operation, the Inquiry held 130 meetings, advertised at different times across metropolitan and regional newspapers and received more than 150 written submissions. A comprehensive Discussion and Issues Paper was released on 12 October 2012 and was widely disseminated.

The Inquiry adopted a transparent approach as to both its methods and the options that were being considered for recommendation to government. Parties were directly invited to address key propositions and provide evidence to either support or argue against the options being considered.

It should also be noted that the matters considered by the Inquiry under the Terms of Reference are not new and have been the subject of numerous other inquiries and commissions in this State and other jurisdictions across the country. All parties that met with the Inquiry and/or made submissions were aware of the key issues and had a clear understanding of the reasons why the NSW Government established the Inquiry.

Principle 6: The simplification, repeal, reform or consolidation of existing regulation should be considered. The Inquiry has recommended the establishment of a NSW Building and Construction Commission which would incorporate all current regulatory functions performed by state government departments and agencies. The establishment of such a body would provide the basis of a single entry point to government for the industry and a co-ordinated, consolidated and organised approach by government to a vital sector of the state economy.

Principle 7: Regulation should be periodically reviewed, and if necessary reformed to ensure its continued efficiency and effectiveness. Common sense dictates that no matter what form regulation takes, and no matter what agency has responsibility for administering and enforcing that regulation, regular reviews are essential to ensure its ongoing effectiveness and of course the need for that intervention.

Independent Pricing and Regulatory Tribunal

The Inquiry also notes that as part of the NSW Government's commitment to reducing red tape for business, the Independent Pricing and Regulatory Tribunal (IPART) has been asked to examine the rationale and design of licenses in NSW and consider options for reform. The Inquiry has examined the Issues Paper that was released by IPART in October 2012, entitled *Reforming Licensing in NSW, Regulation Review-Issues Paper* (IPART Issues Paper).

The IPART Issues Paper sets out the following steps a regulator must take when considering whether licensing is a potential option to address a particular problem or risk:

- there is a clear case for government action;
- there is a need for new action;
- there is a role for regulation; and

- the objectives of the regulation will be addressed through licensing.¹³⁷

While these issues have been briefly addressed under the existing ‘better regulation principles’ above, there is throughout this Report ample evidence that directly addresses the four critical steps identified in the IPART Issues Paper.

Finding

That a licensing system which includes financial requirements for licensees would address issues relating to project capability, and scope and work to instil financial stability and discipline in head contractor and subcontractor businesses.

10. Economic conditions

Many stakeholders expressed the view that while historically there has been a high proportion of insolvencies in the construction sector, the number of insolvencies in recent years had increased due to the prevailing economic conditions and the cessation of the Commonwealth Government’s financial stimulus program. In its submission, the Australian Constructors Association argued that the significant stress faced by:

“.....the residential and apartment sector and, to a lesser extent, the commercial sector in NSW over a number of years is a major factor in the number of insolvencies.”¹³⁸

One of the leading insolvency companies in its submission supported this view, stating that:

“the current spate of insolvencies has arisen due to a significant downturn in the level of construction activity from 2008 and the finalisation of many long term projects in NSW that had been supporting the construction industry since the conclusion of the Federal Government stimulus package. Also there has been a significant increase in the cost of material that has proven difficult for construction companies to fully pass on. In this environment, subcontractors have a lack of commercial bargaining power. This often results in uneconomic decisions being made, such as underquoting, not pressing for timely payment and agreeing to unfair contract terms.”¹³⁹

The Inquiry accepts the validity of these views. The statistics in this summary findings section of the Report show the increase in construction activity primarily through the BER program and the distinct reduction in activity in subsequent years.

¹³⁷ IPART Issues Paper, p. 3, para 3.2.

¹³⁸ Australian Constructors Association submission, 24 September 2012, p 3.

¹³⁹ Witness to the Inquiry.

The economic environment

“Many of these companies got ‘too big for their boots’ too quickly when money was cheap and work was thick on the ground. Post GFC that ‘cheap money’ became very expensive debt that had to be repaid.”¹⁴⁰

If the construction industry is a tough, competitive industry in good times, then it is no surprise that there are more casualties in times when the economic conditions are poorer. Reduction in available capital and more stringent conditions applied by lending institutions on moneys lent, fewer jobs, clients holding the whip hand in contract negotiations, all work towards a financial day of reckoning. One insolvency practitioner expressed the view that a number of contractors were trading while insolvent while a head contractor stated that they and a number of others “were circling the drain.”¹⁴¹

It is also unsurprising that faced with a choice of leaving the industry and work that they are skilled and qualified to perform, and trying again and seeking out that next job, many in the building industry elect to stay in the industry and hope for a windfall job or at the very least, some work that can go to paying debts and surviving in the industry.

There was no shortage of examples provided to the Inquiry of businesses hanging by a thread, seemingly trading insolvent, destined to fail, yet persevering, often with the unfortunate result of dragging in others who may have otherwise avoided debts. The Master Plumbers Association in its submission to the Inquiry’s Discussion and Issues Paper 2012 confirmed this issue stating that:

“(T)here is a major power imbalance as the (sub)contractor has already paid for materials and labour and a contractual cost if they cease work. There is little option but to incur further costs in the desire to obtain past monies as well as the currently increasing ones.”¹⁴²

The following extract from the BIS Shrapnel Report 2012 provides a useful summary of the effect of market conditions and the flow on effect of insolvencies:

“The soft industry conditions.....have created a difficult operating environment for many players in the NSW construction industry. Stiff competition in the prevailing tight market is forcing many builders to price jobs below cost to win business, as low volumes of work contribute towards fiercer competition and lower margins for contractors.

Some contractors and sub-contractors are managing this extra pressure and risk by, for example, exceeding normal bill payment terms (eg. delaying paying creditors to

¹⁴⁰ Witness to the Inquiry

¹⁴¹ Appropriately, this witness was a plumber.

¹⁴² Master Plumbers Association of NSW, Submission 2 November 2012, p. 8.

60 days rather than 30 days) or changing the composition of job sizes (eg. firms that previously only did projects of, say, \$300 million or larger are now accepting commissions as 'small' as \$30 million).

Others have not been able to survive and have gone into insolvency, unable to position themselves to manage the risks appropriately or ride out the downturn. Insolvency in NSW construction has accelerated over the past few years. This has included a number of high-profile contractorssuch as Southern Cross, Cosmopolitan Construction, Baseline Constructions, Kell & Rigby, St Hilliers Construction Pty Ltd, Hastie Group Limited and Reed Constructions Australia Pty Ltd being placed in administration. On top of those, ASIC records reveal that hundreds of smaller construction operators have become insolvent in the last few years, particularly in those sections of the New South Wales industry which are impacting most adversely upon unincorporated subcontractors.

The rise in insolvencies has consequences for the normal functioning of an efficient construction market:

- stakeholders such as developers and banks have become more and more concerned about completion risk, which has resulted in exercising excessive caution, not giving the green light to otherwise worthy projects
- as the number of players in the industry shrinks, concentration risk rises and this means the industry is less well positioned for any future recovery
- there is concern that some companies in the construction industry may continue to trade while insolvent (although it is difficult to determine the number)
- a number of operators may actively choose the insolvency route as a tactic to avoid payment of creditors

Market conditions, in other words, are changing the structure of the industry and modifying behaviour in substantial ways.¹⁴³

Finding

Notwithstanding the long term nature of the high number of insolvencies in the building and construction sector, the current economic conditions have been a substantial contributing factor in the rate of insolvencies.

¹⁴³ BIS Shrapnel Report, November 2012, p. 6.

11. The tendering process

The view presented to the Inquiry on economic conditions in the NSW construction industry supports findings that it is currently in a recessionary period which in turn has reduced the available work, impacted on tendering activity and the strategies of both contractors and subcontractors alike.

The Inquiry has placed particular importance on investigating tendering and procurement practices in both the public and private sectors and the risks involved.

Government tendering

More than half of the respondents to the Inquiry's contractor survey indicated a less than satisfying experience with government tendering practices. Some of the issues raised included:

- poor design specifications and poor quality control;
- greater weighting applied to Best Practice Accreditation Schemes over financial strength of a company;
- less than reasonable prices offered; and
- too much risk being forced onto contractors.

Value for money: a dangerous stand alone

The term 'value for money' has been described as "the benefits compared to the whole of life cost" with the relative value for money being determined by factors such as:

- Price with whole-of-life costs;
- Experience;
- Quality;
- Reliability;
- Timeliness;
- Delivery;
- Innovation;
- Product servicing;
- Fitness for purpose; and
- Value adding components.¹⁴⁴

While the above is designed to be used positively to achieve government objectives, overwhelmingly the advice to the Inquiry from both subcontractors and contractors was that the term 'value for money' had become a euphemism for lowest price.

¹⁴⁴ NSW Department of Finance and Services, *NSW Procurement Guidelines – Tendering Guidelines* December 2011 (Definitions)

Loss of in-house expertise, the transfer of risk and increased cost

Some parties submitted to the Inquiry their belief that a number of key areas relevant to government procurement had diminished and/or that procuring agencies had over time, lost important in-house knowledge and skills. The Inquiry was left in little doubt that the quality of tender process and contract administration varies greatly across government agencies and instrumentalities and also across contracts.

This advice to the Inquiry should be considered in the context of NSW Public Works, a division of the NSW Department of Finance and Services, being brought in to undertake the work that had been contracted by the Government to St Hilliers after that company entered into voluntary administration. The Department of Finance and Services has advised the Inquiry that five projects have been successfully completed and the majority of the remaining projects are due for completion over the next few months.

The Inquiry was presented with the view of the Government as a client passing risk contractually down the chain where in typical circumstances, an inordinate and disproportionate amount of the project risk falls onto the subcontractor. The NSW Commission of Audit (discussed previously in this Report) makes this same point noting that:

*“Government as a client has the power to shift risks and sometimes does this inappropriately. This raises the cost of the project and also means the risk is not best managed. Scope inadequacies and planning risks are best managed by government in whole or in part in its capital procurement.”*¹⁴⁵

In a tender process, contractors are expected to price a project and its individual components without the appropriate detail or design required, while carrying the risk (over which it often has little control) for any detail or design inconsistencies, errors or omissions. In one of the more extreme examples that the Inquiry has heard, the NSW Commission of Audit reported that due to frequent scope changes, contractors bidding for rail projects, include hidden contingencies as high as 50% of cost.¹⁴⁶

Prequalification and financial assessments

With regard to the Government’s Prequalification Scheme and financial assessment processes, the Inquiry heard evidence from witnesses as to the types and efficacy of checks being carried out by financial assessment companies. The Inquiry heard evidence that in relation to Reed Constructions Australia Pty Ltd, that the financial statements supplied by that company demonstrated that it was not a ‘safe bet’ and further checks should have been made.

¹⁴⁵ NSW Commission of Audit, *Final Report*, 4 May 2012, p 309.

¹⁴⁶ *Ibid*

The Inquiry asked Mr John Melliush, one of Sydney's most experienced and eminent insolvency practitioners and a partner at Ferrier Hodgson who was also Voluntary Administrator for Reed Constructions Australia Pty Ltd, for his thoughts on the financial assessment process and system used by the NSW Government. Mr Melliush emphasised that he found:

“.....no particular fault in the financial analysis undertaken[for the Government],having regard to the limited scope of their assignment.”¹⁴⁷

Mr Melliush went on to identify three key issues that needed to be understood about the financial affairs and state of the company:

- “1. The group position should have been reviewed not just the contract holding entity. This will alleviate concerns surrounding security provided and provide a better understanding of the viability of the group.*
- 2. Understand the related party loans and their recoverability and liquidity;*
- 3. Understand the company structure and the income generating areas of the group and their sustainability.”¹⁴⁸*

The above analysis demonstrates that had the Government had in place, adequate assessment requirements and the necessary expertise engaged to understand what the apparent clear implications of key aspects of the company's balance sheets were, the contract may never have been let to Reed Constructions Australia Pty Ltd.

While the above analysis is from one of the leading insolvency specialists in the industry, the concepts he highlights, the manifest risks that were identifiable from the clearly limited information that the company was required to provide to government, are not obscure or difficult to understand.

Government, in the area of tendering, risk analysis, value for money and contract management should be the clear market leader. It cannot sit back and simply state that that there have been relatively few contractors engaged by government that have collapsed. Those that have failed have done so spectacularly with grave results for a large number of subcontractors and suppliers and of course of considerable cost to government. It should not be too difficult to develop an assessment model which will expose a tenderer too unhealthy to be given government work.

The Inquiry is of the view that financial assessments should be made on a rolling basis prior to and during the lifetime of the contract with audited financial statements that are less than six months old and management accounts that are up to date. Appropriately qualified officers must assess these reports and be able to understand the workings of a company's balance

¹⁴⁷ John Melliush, Ferrier Hodgson, Submission 6 November 2012, Annexure B.

¹⁴⁸ Ibid

sheet and must be able upon the basis of experience to recognise the danger signs. Reed Constructions Australia Pty Ltd should become a case study.

Private construction tendering

The Inquiry heard a great amount of evidence that tender bids were routinely being made for zero or even negative margins, just to ensure cash flow continues while hoping the business can survive long enough to pick up variations or until market conditions improved.

Witnesses gave evidence stating that many clients still see ‘value for money’ as simply meaning the cheapest bid made for the work, which in the current poor market conditions remains a somewhat ‘attractive’ proposition for many contractors and subcontractors competing for a reduced pool of work.

As in public tenders, this has led to an increase in instances of ‘bid-shopping’(sic) by contractors that has put further pressure on subcontractors looking for work.

The buying of work

The poor economic climate and accompanying reduced amount of work available has contributed to a sharpening of competition for contracts and a willingness to accept work with very low or negative margins simply to maintain some cash flow. The Inquiry has repeatedly heard of contractors and subcontractors operating on low margins with many hoping to pick up variations during the project to cover costs. This approach leaves no margin for profits and no buffer in the event of unexpected costs – a trigger for insolvency when debts due and payable are greater than available cash and debts owed.

Bid shopping

The Inquiry has heard evidence from witnesses that ‘bid-shopping’, particularly in the current market, regularly occurs once a contractor has been awarded a contract.

The concept of ‘bid-shopping’¹⁴⁹ refers to the contractor calling another round of tenders from its subcontractors to ‘screw down their prices’ by removing all non-essential and extra elements (such as margins for profit or risk) to get the lowest price. This then presents another opportunity to make as much profit (some) from the project as possible, particularly where the contractor may have ‘bought’ the work. The ‘buying’ of work refers to the common practice of taking on work at close to or below cost, simply to keep the cash flow going and the business operating.

The Inquiry has heard this practice is also commonly known as the ‘subbie screw’ and that a number of contractors, while considering it to be tough on subcontractors, see it as a legitimate approach to enhancing productivity, eliminating waste and keeping costs down. It

¹⁴⁹ Unable to resist the pun, some witnesses ruefully referred to “bid chopping”

all depends on one's viewpoint. Evidence was also provided that indicated that this practice is employed in order to generate some profit for the contractor when it has bid at zero or below cost for a project.

From the evidence provided, the Inquiry believes that this practice, exacerbated by poor market conditions, has the effect of forcing subcontractors to price without taking into account their own financial risk and to shoulder the risk passed down from the head contractor for the purposes of keeping their cash flow going and their business operating.

Findings

The prevailing economic conditions have contributed to a decrease in margins in construction contracts.

The financial assessment process for tenderers used by government departments is inadequate.

The value for money criteria is not consistently and meaningfully applied across all government contracts.

12. Inadequacy of existing protections

In NSW, existing protections for subcontractor are regulated by a range of legislative provisions as well as by contractual agreement. Some of these include:

Legislation:

- i. SOPA;
- ii. *Contractors Debts Act 1997* (NSW);¹⁵⁰ and
- iii. *Personal Property and Securities Act 2009* (Cth).

Contractual provisions:

- i. Provisions which allow for cash security and retention funds to be held in trust funds (see for example GC21 (Edition 2) – General Conditions of Contract);
- ii. Dispute resolution clauses which involve a staged (or multi-tiered) process which incorporate alternative forms of dispute resolution mechanisms involving:
 - Negotiation
 - The option of mediation
 - The option of going to arbitration
 - The option of going to expert determination
 - The option of litigation/going to court.

¹⁵⁰ Which like SOPA, does not assist in the event of insolvency.

- iii. Provisions which allow for prepayment;
- iv. Provisions which provide for nominated subcontractors and allow direct payment from the principal/owner to the subcontractor;
- v. Personal guarantees from directors and other office bearers of contractor corporations.

Subcontractors in NSW have the option of recovering unpaid moneys using the provisions of the *Contractors Debts Act 1997* ('CDA'). Section 5(1) of the CDA states:

*"A person (the unpaid person) who is owed money for work carried out for or materials supplied to some other person (the defaulting contractor) can obtain payment of that money in accordance with this Act out of money that is payable or becomes payable to the defaulting contractor by some other person (the principal) for work or materials that the principal engaged the defaulting contractor to carry out or supply under a contract."*¹⁵¹

However there is no protection in this provision that protects subcontractors' payments that are due and payable, in the event of the insolvency of a head contractor.

The *Personal Property and Securities Act 2009* (Cth) is of little practical use to subcontractors.

To recover payment determined by adjudication, resolve contractual disputes arising around the scope of works and payment or enforce those rights arising under existing statutory protections or agreed contractual terms, a subcontractor has a number of options. These range from the more informal option of negotiated discussions to the commencement of legal proceedings in court.

That said, the context in which the expression "existing protection" is examined is the sudden and sometimes fatal impact that the failure to pay or a delayed payment has upon relatively small subcontractors. When such subcontractors have a flimsy asset backing, it is often the case that they rely almost exclusively upon regular cash payments – as one witness put it:

"living day-by-day from pay cheque to pay cheque".¹⁵²

Here, there is no margin of protection which they may place between themselves and a failure to pay or a failure to pay upon time. The point was neatly made in a letter from Canadian construction lawyer and author, Duncan Glaholt, who said that these sentiments animated the Ontario reform initiated in 1983:

"In our reform here in Ontario back in 1983 some basic goals were identified....."

¹⁵¹ *Contractors Debts Act 1997* (NSW), section 5(1).

¹⁵² Witness to the Inquiry.

- a. *Encourage cash flow: Construction industry cash flow is large and fragile. If we are all “six missed meals from anarchy,” as someone said, then the construction industry is two missed progress payments from insolvency.*
- b. *Respect party autonomy: Interfere as little as possible in parties’ power to contract in protecting those without bargaining power.*
- c. *Conserve resources: Economy of remedy is essential. We need to pay close attention to the benefit/burden of any remedy.”¹⁵³*

Bearing this in mind, the adequacy of existing protections must be examined in the context of the bargaining strength of the subcontractor. The context is more often than not, one of substantial bargaining inequality, to the detriment of subcontractors.

As to the legislative mechanisms available for protecting subcontractor payments, the Inquiry has received a great number of comments and feedback directed specifically towards the effectiveness of SOPA including recommended amendment which stakeholders have proposed be made. The effectiveness of SOPA as a means of regulating and protecting subcontractor payments is addressed in a separate section of this Report.

As to the other legislative instruments such as the *Contractors Debts Act*, the Inquiry has heard little which would suggest that they offer adequate protection or are regularly used by subcontractors as a practical means of recovering payment.

Turning to the efficacy of contractual provisions which give subcontractor’s timely cash flow and the right to recover payments against a solvent or insolvent contractor, the Inquiry has found that fair and equitable contractual terms will ultimately boil down to the bargaining power of the parties. Indeed, where parties contractually seek to transfer risk to others, the Honourable Terence Cole QC has observed that:

“[c]ommercial strength and competitive pressures play a major party in determining which party in the contractual chain ultimately bears the risk.”¹⁵⁴

Some standard forms of contracts, such as the NSW “GC 21 General Conditions of Contract”, make a genuine attempt to regulate a subcontractor’s cash flow and require the contractor to hold on trust, retention moneys owing to subcontractors. However, as noted in the Inquiry’s findings on retention funds, without legislative codification, the shortcoming of such standard form clauses lie in the fact that they are not mandatory for inclusion in all construction contracts and therefore do not universally govern behaviour or use of these funds in all contractual relationships in the construction industry.

¹⁵³ Duncan Glaholt, Partner, Glaholt LLP, Ontario, Canada, letter dated 15 November 2012.

¹⁵⁴ Cole, The Honourable Terence. “Understanding Risk – The building industry in the 21st century” *Construct For Chartered Building Professionals* The Australian Institute of Building, January 2008 pp.9 -13 at p.11. (available at <http://www.aib.org.au/lib/pdf/Resources/The%20Hon%20Terence%20Cole%20-%20AIB%20Address%20-%20October%202007.pdf>)

Finally, on the option of going to court, the compelling point made to the Inquiry by many is that for the majority of subcontractors this does not exist as an option. The problems identified include:

- Firstly, legal processes are slow and often drawn out. This has ramifications for smaller subcontractors who need an expeditious solution to payment issues to remain solvent.¹⁵⁵
- Secondly, it is extremely costly and there is a lack of resources and capacity to fund action. As the CFMEU in its written submission stated:

“Even if their claim is 100% successful the amount they recover less legal costs sometimes means that the actual amount they receive is not worth the hassle of making the claim.”¹⁵⁶

- Thirdly, it has been submitted that where the demographics of the subcontracting industry have significantly changed over the last 15 years, an overwhelmingly large number of subcontractors come from non-English speaking backgrounds.¹⁵⁷ For the most part, their lack of knowledge and resources to confidently access to the legal system without the assistance of a legal representative is virtually impossible.
- Fourthly, there is a lack of knowledge and awareness among subcontractors of what rights and enforcement options are out there and available.
- Fifthly, the competitive nature of the industry, significant disparities in bargaining power, fear, threatening behaviour and intimidation from those higher in the contractual chain act as a strong deterrent to pursuing legal action and regularly results in subcontractors commencing or relinquishing claims.
- Finally, with more than one option, this creates confusion for subcontractors and puts them in a difficult position of having to elect between different remedies and different regimes of enforcement. For example, “Do I use SOPA or the Contractor Debts Act? How do they interact, if at all?”

The concerns identified above are far from new and have been recounted time and again. In the NSW Government’s 1996 *Security of Payment for Subcontractors, Consultants and Suppliers in the New South Wales Construction Industry* (1996 Green Paper), the Government then found:

“There is evidence based on comments made by subcontractors and their industry association representatives, that some subcontractors fail to take the necessary actions and remedies available to them under the law (or in contract).

¹⁵⁵ Yasmin King, NSW Small Business Commissioner, Submission dated 14 September 2012, pp. 2-3.

¹⁵⁶ Ibid, p. 14.

¹⁵⁷ Ibid, p. 4-5.

*Reasons for this may include the high cost and time delays in taking legal action, and perceived concerns of victimisation by contractors in relation to future work opportunities. Subcontractors also sometimes choose to waive their legal rights when faced with promises of future payment. If insolvency then occurs, losses are therefore unnecessarily magnified.*¹⁵⁸

Finding

There are no current legislative protections for subcontractors that operate to protect payments owed to them in the event of a head contractor becoming insolvent.

13. Contracts in use in NSW

In NSW, there are a variety of construction (and other related services) contracts in use by both the private and public sectors. Some of these contracts are based on the Australian Standard contract template range, while others have been specifically drafted to suit the customer's requirements. Some of these contracts are discussed in further detail below.

NSW Government contracts

The NSW Government through its various departments and agencies, uses its own range of construction contracts, including the commonly used 'GC21' contract for government projects.

These contracts are available for use by the various government departments and agencies for procurement purposes. While some departments/agencies will use the contracts unamended, amendments can and are made to insert special conditions or remove provisions, depending on the requirements of the business.

GC21

The GC21 contract has received mixed reviews from those in the construction industry. A number of parties appearing before the Inquiry agreed that it was a good contract that utilised a co-operative approach. Notably, GC21 contains the consensual form of the trust clause (clause 33.7).

As one would expect, the GC21 provisions appear to weigh heavily in favour of the principal. The contract shifts liability, risk and penalties to the head contractor (much of which it has no control over). This risk is typically then pushed down the contracting chain to rest uneasily on the shoulders of the subcontractor.

¹⁵⁸ 1996 NSW Green Paper, 1996, p. 5, section 2.6.

The NSW Construction Agencies Insolvency Taskforce's submission to the Inquiry sets out the construction procurement framework and has been included in the appendices section of this Report.

Other contracts in use in the NSW construction industry

A number of different contracts are utilised throughout the residential and non-residential construction industry and its related trades, developed by various organisations such as the Housing Industry Association, NSW Fair Trading, Master Builders Association, Royal Australian Institute of Architects, the Institute of Civil Engineers and the Property Council of Australia. Examples of these contracts include:

- Australian Building Industry Contract (MW-2008 Major Works Contract);
- The Royal Australian Institute of Architects (JCC A 1995 (Building Works Contract with Quantities));
- Housing Industry Association (Building Contract for New Dwellings);
- NSW Fair Trading (Home Building Contract for work over \$5,000); and
- Property Council of Australia, Project Contract (PC – 1, 1998).

The Inquiry heard evidence that these contracts are available (some for a cost) for use in different areas of the construction market enabling the client (in most circumstances) to select a contract suitable for their purposes. Aside from these 'organisational' contract types there are a number of different methods or contracts to deliver a project including:

- Alliance contracts – where the Government agency works collaboratively with private sector parties ('non-owner participants') to deliver the project;
- Managing contractor - contractor undertakes a significant part of the project manager role;
- Design and construct - the client provides a project brief, which may include some concept design, and specifies performance and quality requirements. The contractor engages consultants to prepare or complete the concept design, develop the design and prepare construction documentation; and
- Construct only - tenders for the construction contract are not called until the whole of the work is designed. While the tender documents include detailed drawings showing the proposed work, the contractor is nevertheless required to complete the design so that it is suitable for construction.

The different contract types allow different circumstances and challenges to be worked into the contract.

Improvements

The Inquiry observed that there are some contracts being used in NSW that do provide some protections or at least potential protections for subcontractors.

The Inquiry heard that in particular the Department of Defence construction contracts contain provisions requiring the mandatory establishment and use of trust accounts to hold progress payments due to subcontractors.

It was also noted by the Inquiry that there have been improvements recently made to the GC21 Edition 2 Contract, including limits on payment periods for certain subcontractor work amounts, statutory declarations, and requirements for a contractor to hold on trust, *any* cash securities (retention) provided by subcontractors *and* payments made by the principal which are due to subcontractors which have not been paid. Based on the evidence provided to the Inquiry, it appears there is a general lack of awareness in the building and construction industry that these trust provisions are a contractual condition.

Findings

Clients/principals use the contract to shift as much of the project risk away from themselves and onto the head contractor and that a disproportionate amount of that risk falls to the subcontractor who has no direct contractual relationship with the client/principal.

Subcontractors often lack the skills to understand what are often complex contracts containing unidentified risk.

There are contracts available that provide for better protections for subcontractors and these should be promoted within the industry.

There is a lack of awareness among government contractors of the trust account requirements in the current NSW Government's GC21 Edition 2 standard construction contract.

Retention money

Term of Reference

Paragraphs 2, 3(b) and 3(f) of the Terms of Reference require the Inquiry to consider payment practices affecting subcontractors, opportunities to simplify debt collection processes and the effectiveness of trust arrangements to protect subcontractor payments. The matter of retention moneys falls within each of these Terms of Reference.

What is retention?

The holding of ‘retention moneys’ has been a long standing practice in the building and construction industry. In the National Electrical Contractors Association (NECA) ‘Payments and Retentions – Owners Handbook’ retention is defined as:

“...holding back a percentage of the progress payments agreed upon for work properly performed.”¹⁵⁹

Hudson’s ‘Building and Engineering Contracts, 12th edn’ states that:

“Retention or ‘retainage’ (US) or ‘holdback’ (Canada) is almost universal in more sophisticated construction contracts where interim payments are required to be based on periodical valuations of the work done as opposed to fixed stage instalments.

.....the intention was simply to provide for partial payment during the construction period and to defer full payment of a final balance until completion, so as to confer a degree of commercial security on the Employer against possible breaches or failures of the Contractor...”¹⁶⁰

The holding of retention moneys either by the principal or the head contractor, serves as an incentive to ensure the due and proper performance of the contract.¹⁶¹ In the case of subcontractors, retention money is held by the head contractor as both an incentive for the subcontractor to complete the project in an expedited manner¹⁶² and as a safeguard against defects for which the subcontractor may fail to remedy. In this way, the retention fund provides the head contractor with:

- a simple and virtually costless means of recovery against the subcontractor; and

¹⁵⁹ NECA ‘Payments and Retentions – Owners Handbook’, undated p. 3.

¹⁶⁰ Wallace, I.N.D., and Hudson, A.A., *Hudson’s ‘Building and Engineering Contracts, 12th edn’*, 2010, Thomson Reuters, London, p 854.

¹⁶¹ AS 2124-1992 General Conditions of Contract, clause 5.1.

¹⁶² Hinze, *Construction contracts*. 3rd edn. 2010 McGraw-Hill, New York, p.530.

- a means of recovery against the subcontractor which is safe from the insolvency of the subcontractor.¹⁶³

Retention arrangements

Retention moneys are typically accumulated by the head contractor from interim or progress payments due and owing to the subcontractor. That is, as the head contractor pays each progress claim to the subcontractor, it deducts a percentage from that progress claim to be used as a provision against events which have not yet occurred and about which no determination has yet been made – namely, should the need arise, the necessity to use those funds to rectify the subcontractor’s defective work or materials or pay someone else to complete the contract works. The amount to be deducted and withheld from each progress payment is by agreement between the parties and is usually in the order of 5% or 10% of each progress payment until the total amount of moneys retained is equal to 5% of the contract sum.

Once the subcontracted works are complete and a certificate of practical completion is issued, the contract will then usually provide that such retention or cash security is to be returned, in part, to the subcontractor. Often, the agreed percentage of that which is returned to the subcontractor is 50% and the other half still held by the head contractor.

The remaining half of the retention moneys held by the head contractor is released to the subcontractor at the end of the defects liability period, which is usually stipulated to be for a period of 12 months. The security which is retained throughout the defects liability period is for the purpose of, should the need arise, rectifying faulty and defective work of the subcontractor.¹⁶⁴

Forms of retention

Any discussion concerning retention and the form it takes relative to the client/principal and head contractor and the head contractor and subcontractor, needs to recognise that the industry is made up of many different sized businesses and many different sized projects and for that reason a one size fits all proposal will not work. A number of head contractors told the Inquiry that they provided subcontractors with a choice as to what form retention would take.

Retention generally comes in one of two forms; bank guarantee or cash retention in most cases retained as a portion of each progress payment. Whilst security in the form of bank guarantees is widely used on large commercial building and construction projects, cash is still

¹⁶³ Fitzpatrick, F. “Retention funds in Building Contracts” 141 NLJ 1007.

¹⁶⁴ McMullan, J. “Contract Administration Principles: Guide To Engineers”, McMullan Solicitors online publication, January 2011 (available at: <http://www.mcmullansolicitors.com/uploads/contract-administration-principles-2011.pdf>) at pp. 62-63.

considered to be the most common form of security used in subcontract agreements. In its submission to the Inquiry, the Housing Industry Association for example noted the:

*“.....limited use of retention funds within the residential construction industry.”*¹⁶⁵

During its discussions with stakeholders, the Inquiry noted that the alternative option of performance bonds was rarely used in this country.¹⁶⁶ The use of such bonds is prevalent in the United States,¹⁶⁷ where it is a legal requirement on some projects. The Inquiry has noted that there does not appear to be a market, nor an appetite for one, in NSW for performance bonds.

Cash retention

In most instances between 5% and 10% of the value of the subcontract works is held as retention. This sum is arrived at by the head contractor withholding moneys from progress payments up to the point where the agreed percentage of the contract is reached.

Bank guarantees

A bank guarantee is usually obtained by giving security to a bank to hold, in return for a certificate up to a value required under a contract. An example of this may be where a contractor (or subcontractor) receives a bank guarantee in exchange for security interest given by the contractor or subcontractor to the bank.

The Inquiry has heard evidence from witnesses that while this may be a more secure option and assists with the cash flow of their business (with many of the top tier contractors expressing that was how they operated) many subcontractors cannot afford bank guarantees. The cost of a bank guarantee ranges from 1.25%-2.5% of the amount secured plus establishment fees.

Many subcontractors were also understandably reluctant to offer the family home or other property as security in an industry where margins were tight and work not always available. Others simply did not have the appropriate level of security to facilitate a bank guarantee.

This situation was reversed for big subcontractors that *“generally use guarantees”*¹⁶⁸ and head contractors readily submitted to the Inquiry that they only use bank guarantees.

¹⁶⁵ HIA, Submission, dated 2 November 2012, p. 15, para 9.3.1.

¹⁶⁶ See generally, *Surety bonds in the Building and Construction Industry; Problem or Solution Seminar Papers* August 1993, National Public Works Council (NPWC), (1993 NPWC Seminar Paper).

¹⁶⁷ All Federal and State Government projects in the United States required the head contractor to take out a performance and payment bond to ensure performance to the Principal is made, and that payment is made to subcontractors. These are legislated at both State (Little Miller Act) and Federal (The Miller Act) levels.

¹⁶⁸ Witness to the Inquiry

What is happening to retention moneys?

The point that has been repeatedly made to this Inquiry is that many subcontractors experience great difficulty in getting retained amounts released by head contractors. In circumstances where subcontractors find it both extremely costly and time consuming to recover cash retentions, the sad reality is that they are sometimes not recovered. As Ms Yasmin King, NSW Small Business Commissioner explains in her written submission to the Inquiry:

“Retention money

...

Whilst insolvency of head contractors and developers is a huge issue for sub-contractors when accessing retention monies, this issue still exists when head contractors or developers are solvent. Retention monies are regularly used as a mechanism for head contractors to prop up their working capital and cash flow. For example warranty periods may not commence from the day that a sub-contractor completes their work, but instead from the day that the actual development is completed. Therefore for sub-contractors who are involved early in a project, they may then have to wait for the whole project to be completed before the warranty period commences. Then at the end of this period, the battle then begins for the sub-contractor to recover the retention money, often not knowing whether they will receive a cheque or a defect notice. Head contractors are then also able to delay the final inspection time which creates further uncertainty for the businesses attempting to manage their cash flow.”¹⁶⁹

Indeed, many subcontractors are of the opinion that they will rarely see the return of all their retention moneys, and anything that they do get back from the head contractor is often treated as somewhat of a bonus. One subcontractor organisation told the Inquiry that:

“(subcontractors)....will accept 60% of something because it is better than 100% of nothing.”¹⁷⁰

For some head contractors, the implications of this mentality may have a negative impact on pricing throughout the contracting chain. As the Australian Institute of Quantity Surveyors (AIQS) in its written submission to this Inquiry states:

“.....This attitude may be indirectly adding to the inflated costs of subcontractors as they are assuming they will get paid only 95% of the costs that they have submitted. It may also be a contributing factor to insolvencies if they are pricing projects with margins less than 5% but consistently are having their retention withheld.”¹⁷¹

¹⁶⁹ Yasmin King, NSW Small Business Commissioner written Submission dated 14 September 2012, p. 3.

¹⁷⁰ Witness to the Inquiry.

¹⁷¹ Australian Institute of Quantity Surveyors, Submission dated 4 September 2012, p.8.

There is little debate about the legitimate use and reasons for holding retention. Clients and head contractors want some assurance that those with whom they contract, do the work. This Inquiry is not recommending that the practice of holding retention be prohibited. It plays an important role as:

- *“an incentive to the contractor and protection of the employer: Calvert v London Dock (1838) 2 Keen 393; and*
- *“protection against failure to rectify defects, at least as far as the second half is concerned, since a certificate of making good is a condition of its recoverability.”¹⁷²*

However the money *must be protected and the rights of both contractors and subcontractors to release the retention sums, safeguarded.*

Retention money held by the head contractor is, in every conceivable way, *the subcontractor’s money* until it is properly demonstrated that the head contractor has a contractual right to resort to the fund. Cheque book persuasion is not the way to deal with retention issues.

The Inquiry’s Discussion and Issues Paper 2012 raised the difficulty that subcontractors regularly face in having retention moneys released by head contractors. Since the release of that Paper, many more examples and evidence of the misuse of retention funds by head contractors have emerged.

The most glaring, fresh example of the loss of subcontractor retention moneys relates to Reed Constructions Australia Pty Ltd (RCA). In a later section of this Report the statutory construction trust and the RCA insolvency is discussed in some detail. Briefly though, the Liquidator, Mr Mark Robinson of PPB Advisory, found that the more than \$7 million in subcontractor retention moneys held by RCA had:

“.....been used to fund working capital requirements on RCA projects and as at the date of appointment, the Company had no cash at bank.”

The Inquiry however, does not only rely upon one high profile insolvency to support its findings on retention moneys. Here are some quotes from subcontractors about their experience with retention moneys:

“Losing \$30,000 from 1 [one] head contractor is a huge loss to a subcontractor and can be the difference between continuing business and having to shut down and sell off personal assets just to keep afloat at home.”¹⁷³

¹⁷² Davis, R. ‘Construction Insolvency – Security, Risk and Renewal in Construction Contracts’ 4th edn, 2011, Thomson Reuters, London, p. 83.

“[Retention] never goes to the subcontractor, might as well write it off. [The] Head Contractor finds discretions (sic) to stop subbies getting money (e.g. contract variations requested by the head contractor but no written documentation to evidence this...)”¹⁷⁴

“70 per cent of subbies do not receive their retention monies and often for minor, silly reasons”¹⁷⁵

“Retention monies are regularly used as a mechanism for head contractors to prop up their working capital and cash flow”¹⁷⁶

“The Head Contractor uses these retention funds to operate their own businesses when the money is not actually theirs.”¹⁷⁷

“Most smaller builders know it is a retention fund and must be returned at some stage. Larger builders seem to treat it as a bonus for letting the contract or similar”¹⁷⁸

“Retention funds are seen by some head contractors as a ‘bonus’ that they can secure with a bit of legal argy bargy” and

“the mindset is that ‘the money is ours and you will have to get it off us or sue us if you want it.”¹⁷⁹

Further confirmation of the widespread use of retention moneys as general revenue available for the head contractor’s use came from an experienced builder who had worked for Kell and Rigby who told the Inquiry that:

“...in my experience, if I had to pay a subcontractor I would, even if that meant using the retention money of a different subcontractor. This is the ‘false economy’ of retention money”¹⁸⁰

The Inquiry also heard that:

¹⁷³ Witness to the Inquiry.

¹⁷⁴ Witness to the Inquiry.

¹⁷⁵ Witness to the Inquiry.

¹⁷⁶ Yasmin King, NSW Small Business Commissioner, Submission 14 September 2012, p. 3.

¹⁷⁷ Witness to the Inquiry.

¹⁷⁸ Witness to the Inquiry.

¹⁷⁹ Witness to the Inquiry.

¹⁸⁰ Inquiry case study, October 2012.

“Where retention is in the form of bank guarantees for the head contract but cash for the lower level contracts it is clearly the position that the retention in the form of cash is used to pay for job costs and not locked away as retention.”¹⁸¹

Consider the following evidence of tactics used by some but by no means the majority of head contractors to avoid *returning* retention moneys to subcontractors:

“These days it’s very rare to hear of retentions being returned to subcontractors so they might as well write them off. The head contractor finds defects to stop subbies getting the money. They rely on contractor variations for which there is often no written documentation to evidence this. For example, the contract specification might say to use blue nails, but the head contractor asks the subbie to use red nails and as requested the subbie does so. But at the end of the project the subbie is denied his retention by the head contractor because he didn’t follow the contract specification of blue nails.”¹⁸²

Evidence to the Inquiry shows what happens when the head contractor becomes insolvent:

“We have had experience in head contractors becoming insolvent and I think the most we have ever recovered after quite a long process is about \$0.03c in the dollar of the debt owed, so basically nothing.”¹⁸³

The Inquiry accepts the overwhelming evidence provided to it and the findings of previous inquiries that subcontractors frequently do not receive retention moneys due to them at practical completion and at the conclusion of the defects liability period. At a meeting with the National Electrical Contractors Association and one of its members, the Inquiry was told of one building company operating in NSW that had accumulated \$1.5 million in 2011/12 from retention money it had not paid out to subcontractors. Whether this is due to the company simply refusing to pay, confecting some dispute about the quality of the work or whether subcontractors ‘forgot to claim,’ makes no difference. *This was subcontractors’ money.*

The extraneous use of retention funds by the head contractor, while certainly not illegal in NSW, will always place the subcontractor’s money at some risk of not being returned. The question asked by the Inquiry was, why should the builder be able spend what is not its money?

If the answer is, that this is the way that the industry operates, or that it is somehow linked to tight margins in a tough economic environment, then that is no sufficient answer and practices must be made to change.

¹⁸¹ Crisp Legal (prepared by Paul Stokoe) email submission, dated 25 September 2012.

¹⁸² Witness to the Inquiry.

¹⁸³ Witness to the Inquiry.

To some degree an admission that unrestrained extraneous use of retention moneys is “necessary” must be a statement that the business has insufficient cash or other reserves of its own to cover its ongoing costs and is trading dangerously close to insolvency. It is a financial viability issue.

The Inquiry has found that many head contractors and builders are using subcontractor retention funds for activities that include:

- paying off the tail end of a previous project;
- investing in other business ventures;
- paying business overheads and head office staff wages;
- investing funds on the short term money market;
- discretionary personal purchases.

Of course at the end of the day, in the event of the insolvency of the head contractor, as one witness said,

“When they retain the money and they go bust the retention money goes with them.”¹⁸⁴

“Take the sugar off the table”¹⁸⁵

The evidence seen and heard by the Inquiry about the loss of retention money and the time and cost of disputes to extract those funds supports previous findings such as that made in the 1996 Price Waterhouse Report when it states:

“..... not uncommon for such monies to be forfeited unfairly or negotiated away in response to perceived problems and disputes.”¹⁸⁶

Responses from the industry and its stakeholders about the use of retention sums and the important role they play in both the active ongoing contractual relationship between parties and in the event of a head contractor’s (or principal’s) insolvency were sought. As part of these discussions, views were sought on the effectiveness of trust arrangements to protect retention moneys.

The majority of witnesses and written submissions to the Inquiry, indicated widespread support for the view that retention moneys should be held in a trust account until they are due and payable, protecting the money throughout the duration of the contract and in the event of the insolvency of the head contractor.

¹⁸⁴ Witness to the Inquiry.

¹⁸⁵ Quote from a witness to the Inquiry – a pithy way of saying that the ways of temptation were most of the problem and that if the opportunity to misuse the funds was restricted, change would follow.

¹⁸⁶ 1996 Price Waterhouse Report, p. 21.

Some submissions raised the option of prohibiting retention sums. The reasoning behind this appears to relate directly to evidence that retentions are being withheld by contractors for extensively long periods after work has been completed,¹⁸⁷ or simply not paid. A number of submissions considered retention to be:

“a disproportionate remedy applied across the board whereas only a small proportion of contractors fail to honour defects obligations”¹⁸⁸

and that in many cases the amounts retained are not sufficient to cover the costs of rectifying defective work.¹⁸⁹

The Inquiry is of the view that retention moneys should be held on trust, and that retention is an important contractual mechanism that works to ensure completion and an appropriate standard of work.

The view of one head contractor

Mainbrace Constructions (NSW) Pty Ltd provided a useful submission to the Inquiry on a range of matters. On the issue of retention funds, the company acknowledged that it was:

“.....hard to argue that the subcontractors retention money should not be held in trust.”¹⁹⁰

The company raised a legitimate concern about the impact that placing these funds in trust might have on its own ability to secure bank guarantees that it is required to provide to its client for its own retention. Mainbrace is concerned that if this money is ‘locked up’ in trust then the security available to them to provide its retention to the client is diminished.

It is encouraging to see this company and many others acknowledge the need for reform in this area and offer possible solutions to the issue. The Inquiry has noted that Mainbrace has agreed with the proposal that SOPA extend to being able to resolve disputes through the adjudication process in relation to retention moneys and bank guarantees. The Inquiry makes recommendations on this issue later in this Report.

In implementing any reform in this area, government should consider the effect of retention throughout the contracting chain.

¹⁸⁷ Witness to the Inquiry.

¹⁸⁸ Davis, R., 2011, p. 83.

¹⁸⁹ Ibid.

¹⁹⁰ Mainbrace Constructions (NSW) Pty Ltd, Submission 2 November 2012, p. 5.

In presenting what is obviously a bleak picture of the practices engaged by some head contractors and builders, it is important to acknowledge that there are many in the industry that do not engage in such abuses of retention funds.

The Inquiry has also considered the importance of the fact that for many head contractors, especially among those in the top tiers, *“there is no interest for us in subbies going broke.”*¹⁹¹

Some contractors who came to the Inquiry stated that cash retention belonging to subcontractors was protected in segregated accounts and paid when required. One contractor stated that its practice was for:

“funds to be kept segregated in an account” and that while they could be *“put into an IBA [interest bearing account] for a specific period...[you] can still make payments to your subcontractors when required.”*¹⁹²

The Inquiry was unimpressed, but not surprised to learn that while some contracts contained provisions requiring the holding of retention sums in trust or in a joint account the reality was that this requirement was often not followed. The Reed Constructions Australia Pty Ltd case illustrated previously is just one example.

Uses and abuses: whose money is it anyway?

The Inquiry accepts the overwhelming evidence provided to it and the findings of past inquiries that subcontractors frequently do not receive the retention moneys due to them at practical completion and at the conclusion of the defects liability period.

It has been made clear to the Inquiry, that retention sums have been subject to abuse by holding parties in a manner that has placed considerable strain on the supply chain, predominately on subcontractors and their ability to maintain cash flow to their business.

The human cost

The grief that accompanies a substantial loss of money for work performed has been enough to push some subcontractors to the edge. One witness working in the finance industry who regularly deals with subcontractors after they had lost money through insolvency, gave evidence that he kept next to his office phone a list of grief counsellors, suicide hotlines and other support numbers. Too often he judged it necessary to pass them on to troubled clients.¹⁹³

The Inquiry has concluded that in many cases, the true purpose of a retention fund has been corrupted and made into a ready-made fund that is available to the holding party for whatever

¹⁹¹ Witness to the Inquiry.

¹⁹² Witness to the Inquiry.

¹⁹³ Witness to the Inquiry.

purposes they choose to use it, regardless of the risk of being unable to repay it. Like “cheque book persuasion” it has become a weapon, not a protection.

The chase

The point that has been repeatedly made is that many subcontractors experience great difficulty (and cost and time expenses) in retrieving retention money. The sad reality is that they are often not recovered and the evidence heard by the Inquiry confirms that, this imposes considerable financial stress and strain upon subcontractors.

Examples provided to the Inquiry from two respondents stated,

*“Retention is supposed to be released at [the] end of [the] project and the remainder is supposed to be released one year after completion. This is never the case as we are constantly chasing retention.”*¹⁹⁴

*“At the moment we are attempting to recover our final retention amounts from [a] commercial building group of Sydney, despite assurances it is in the system the payment is 3 months overdue.”*¹⁹⁵

Some subcontractors, whether due to previous experience or simply a need to concentrate elsewhere in looking for work, write off the debt as a necessary expense in doing business. However for most subcontractors every bit adds up and affects cash flow and the financial viability and stability of their business,

*“Most builders do come through eventually with retentions but you must keep on them. As for smaller retentions held, when you try and chase them it is like the head contractor says are you serious you’re chasing me for a retention of \$100 from a project 12 months ago, but all these small retentions add up [to] an exorbitant amount of money to us.”*¹⁹⁶

This practice of withholding retention may be made easier for smaller amounts when, as one witness stated, head contractors operate on the assumption that:

*“.... it is not worth the subcontractor’s time and money to chase these often small amounts, and know that more than likely the subcontractor won’t bother chasing these outstanding retention funds.”*¹⁹⁷

¹⁹⁴ Witness to the Inquiry.

¹⁹⁵ Witness to the Inquiry.

¹⁹⁶ Witness to the Inquiry.

¹⁹⁷ Witness to the Inquiry.

Doing away with retention

The Inquiry is of the view that appropriately used and in accordance with contractual conditions, retention played an important role in providing security for the completion of works and completion in accordance with required standards of work.

Keeping retention sums in trust

The Inquiry has received almost unanimous support for the protection of retention funds by means of ring-fencing in a trust account.

The idea of protecting retention moneys in a trust account in the event of insolvency has been recognised in many contracts. For example in *Re Tout and Finch [1954] 1 All ER 127; 1 WLR 178* the subcontract provided that:

“If and to the extent that the amount retained by the employer in accordance with the main contract includes any retention money the contractor’s interest in such money is fiduciary as trustee for the subcontractor...[and] ...shall thereupon immediately set aside and become trustee for the subcontractor of a sum equivalent to the retention money and shall pay the same to the subcontractor on demand...”¹⁹⁸

As long as the words “*fiduciary as trustee*” are sufficiently clear to show that a trust is intended for the benefit of subcontracts, the court found that the subcontractors were entitled to a declaration that the contractor’s rights to retention were held in trust for them and:

“that the liquidator was bound to pass over their proportion on receipt from their employer.”¹⁹⁹

As stated in the Inquiry’s Discussion and Issues Paper 2012:

“....common sense dictates that retention funds should be deposited and remain in a clearly entitled separate trust account to which the contractor and the subcontractor are joint signatories.”²⁰⁰

It became apparent to the Inquiry that, in the words of one witness:

“in theory, the contractor [is] supposed to set up a joint account with the subcontractor”²⁰¹

¹⁹⁸ *Re Tout and Finch [1954] 1 All ER 127; 1 WLR 178 at 182 per Wynn-Parry J. Davis, R., 2011, pp. 297-298.*

¹⁹⁹ *Davis, R., 2011, pp. 297-298.*

²⁰⁰ *Inquiry’s Discussion and Issues Paper 2012, p. 46.*

²⁰¹ *Witness to the Inquiry.*

which appears to have its basis in a contractual obligation when reviewing contract provisions used in NSW. However the practice itself appears to be rarely used.

In *KBH Constructions Pty Limited v Lidco Aluminium Products Pty Limited* (Unreported 27/06/1990), the Court considered a clause in a building contract (in similar terms to clause 10.24.05 of SC JCC A) which provided:

*“10.24.05 The interest of the Builder in the amount so retained shall be fiduciary as trustee for the Sub-Contractor but subject to the provisions of Clause 10.26 and without any obligation on the part of the Contractor to invest the same or account for any advantage that he may derive from the moneys so retained.”*²⁰²

His honour, Justice Giles in the Supreme Court of NSW, held that pursuant to these provisions [clause 10.24.05]:

*“In my view, in the present case the builder is obliged to appropriate and set aside the retention moneys in a fund to be held on trust for the subcontractor, subject to its entitlement to have recourse thereto in the circumstances permitted by the subcontract [clause 10.26].”*²⁰³

On this basis it was noted that any entitlements the contractor may have had did not affect the conclusion that the *“moneys were held on trust for the relevant subcontractor.”*²⁰⁴

Amongst the criticisms for this approach, some witnesses submitted that, *“if you try and ring-fence retentions, [the] big boys will say ‘fine, we’ll take bank guarantees instead of cash’”*²⁰⁵, which may then lead to a situation where those subcontractors who were unable to gain such guarantees losing work and becoming financially stressed.

Others raised the argument on behalf of builders in saying *“the big building companies will state that they need that money”*²⁰⁶ and that they *“believed many would say they would go broke if they could not use/have this money”*²⁰⁷.

However, the great majority of both contractors and subcontractors agreed with the fact that retention funds owing to subcontractors should be placed in trust accounts.

One large contractor of impeccable repute, when asked whether ring-fencing the retention payment would have an impact on their company responded:

²⁰² *KBH Constructions Pty Ltd v Lidco Aluminium Products Pty Limited* (Unreported 27/06/90)

²⁰³ *Ibid*, per Giles J at p. 17 (The SC.JCC.A subcontract) and p. 19 (Conclusion). See also Jones, D.S., “Structuring Contracts to Protect Against Insolvency” (1991) 21 *Australian Construction Law Newsletter* 34 at 45.

²⁰⁴ *Ibid*.

²⁰⁵ Witness to the Inquiry.

²⁰⁶ Witness to the Inquiry.

²⁰⁷ Witness to the Inquiry.

“No impact, we would put the private money in a public (sic) trust account.”²⁰⁸

Another witness said that he agreed with the concept noting:

“that subcontractor has earned the money, ground rules could be sorted and no one needs to be disadvantaged.”²⁰⁹

In terms of who should hold the retention money on trust, it has been suggested that this can be done by the contractor (or in the case of the principal/head contractor, by the principal) who would become a trustee under the fiduciary obligation to disburse the sums as required. The Inquiry did note some objection to this proposal for the contractor to hold the funds, instead opting for a third party to hold the retention funds.

One suggestion provided to the Inquiry on this matter, was from the Small Business Commissioner who proposed the establishment of a “Subcontractor Retention Funds Scheme” using a central fund similar to the NSW Retail Security Bond Scheme to be administered by the Dispute Resolution Unit of the Office of the NSW Small Business Commissioner. This was not considered the most appropriate solution as retention sums could be held within a statutory construction trust account as a ledger entry, thereby requiring less administrative and cost burdens. The concept of the statutory construction trust is dealt with in detail in a later section of this Report.

Improving the situation

In light of the overwhelming response to the Inquiry regarding the use and abuse of retention sums designated for subcontractors, the Inquiry has considered a number of protective measures to safeguard this money. The Recommendations section of this Report provides further details. The Inquiry, while accepting the evidence given to it that demonstrates that there are significant problems with retention moneys, also acknowledges that at the upper end of the contracting spectrum particularly, companies are run professionally, and treat their subcontractors and suppliers with respect and with fairness.

The solution though, as it is for all recommendations put forward by this Inquiry, must apply to the industry as whole. That is not to say that in considering these recommendations, Government should not look at the different sectors of the industry and apply some common sense. There cannot be however, rules that apply to the top tier contractors and then other rules that may or may not apply to the rest of the sector. The larger the company, the larger the losses typically are when insolvency occurs.

Retention moneys must be placed in a trust fund. The discussion and analysis of the statutory construction trust in the following sections of this Report includes an outline of current

²⁰⁸ Witness to the Inquiry.

²⁰⁹ Witness to the Inquiry.

examples of the trust operating in building contracts. NSW Government contracts through GC21 already requires:

“.....a contractor to hold in trust any cash securities provided by subcontractors and payments made by the principal which are due to a subcontractor or supplier - and which have not been paid. The contractor must pay this money into a trust account in a bank the next business day after it is received and it must be held in trust until it is paid to the party entitled to receive it.”²¹⁰

The Inquiry’s Discussion and Issues Paper 2012 noted the absence of any witness to the Inquiry who was able to present a cogent case against the idea that retention funds should be held as a genuine trust fund and such moneys placed in a separate bank account with two joint signatories.²¹¹

In light of the evidence presented to the Inquiry, it is recommended that:

- a) all retention funds are to be deposited into a trust fund.
- b) upon agreement between the principal and the head contractor and/or the head contractor and subcontractor as the case may be, the funds be paid out.
- c) Retention sums cannot be used by the holder of those moneys for any purpose other than for the reasons afforded to it under the contract.
- d) SOPA deal with disputes relating to bank guarantees and retention moneys

²¹⁰ Submission from NSW Construction Agencies Insolvency Taskforce (in the appendices section of this Report).

²¹¹ Why should it be any different for progress payments destined to the subcontractor?

The Education Chapter

“Education costs money, but then so does ignorance.”²¹²

“If someone is going down the wrong road, he doesn’t need motivation to speed him up. What he needs is education to turn him around.”²¹³

Paragraph 3(c) of the Terms of Reference asks that the Inquiry consider strategies that can improve financial management skills in the industry.

This Inquiry was not established to address new problems. Insolvencies have been increasing in the industry for some years now. The major causes of insolvency recorded by ASIC remain the same as they were years ago. The economic conditions, harsh as they are now for head contractors and subcontractors, did not spring up overnight.

The need for a better informed and more financially aware industry membership remains as true today as it was in 1992 when the Construction Industry Development Agency (CIDA) formed the Security of Payment Action Team to research the security of payment problem and propose strategies to reduce the size and cost of the problem.

In its Final Report the Security of Payment Action Team recorded a finding that a:

“Lack of financial expertise, bad management, lack of cost control, and shortage of working capital featured prominentlyas causes of failure.”²¹⁴

To address these serious issues, the Action Team recommended:

“That all contractors, subcontractors and consultants should develop management and financial skills training including an understanding of cash flow characteristics, resources planning and mobilisation, the need for and use of adequate working capital, the need for on-going research and development, the need for on-going training and skills enhancement and the need for overall business and corporate planning.”²¹⁵

The importance of education and training remains unchanged. Considered to be an essential element for the survival of the industry and its participants, the question of education was a universal concern raised by every witness to the Inquiry and one upon which there was

²¹² Claus Moser.

²¹³ Jim Rohn, Author.

²¹⁴ Construction Industry Development Agency (CIDA), Security of Payment Action Team, *Security of Payment – Final Report*, 1994, p.15.

²¹⁵ *Ibid*, p. 16.

striking unanimity. A lack of a financially relevant education is closely linked to one of the important and repeated themes which came across to the Inquiry from many witnesses; the somewhat paradoxical danger of “growing too fast”. Many witnesses pointed out that there was something like a Minoan tragedy almost certain to unfold when, like Daedalus and his son Icarus, companies fly too high and too close to the sun without the appropriate knowledge of their business and the industry and have therefore fallen into insolvency and grief.

Not one person in submissions or in meetings held during this Inquiry, has disputed that there is a chronic lack of solid financial and business management skills across the industry. This is not to say that there are not a great many highly qualified and highly successful individuals and companies right across all sectors of the industry. Clearly there are.

However time and time again, the Inquiry was told by witnesses from all parts of the industry, subcontractors and head contractors working in the residential, civil and commercial sectors, that the levels of basic financial literacy of the level and type that would enable you to operate somewhat competently and hopefully legally were close to, or in fact, hopeless.

The Inquiry was often told that a good tradesperson or builder does not necessarily make a good or even competent business owner.

One submission included the following statement:

“.....training and education is an answer, but many of my members have not completed basic high school education. They are good with their hands, have business acumen and respect verbal agreements and hand shake deals, which surprisingly can involve millions of dollars.”²¹⁶

There is no good reason why a general lack of financial awareness and basic wherewithal, should be tolerated in the sector. The costs are too great to the business owner and those affected when they inevitably collapse into insolvency. The education of the sector must address the following key issues among others:

- Poor contract administration practices;
- Poor record keeping practices;
- Poor business and financial management practices; and
- Poor knowledge of legal processes.

At the other end of the spectrum, it was also submitted to the Inquiry that those in the position of ‘Project Managers’ need to be formally trained and qualified as:

²¹⁶ Witness to Inquiry

“most project managers have little or no experience within the industry and to put it simply, if you can’t perform some or all of these works yourself then how can you determine a cost, procedure, risk assessment and coordinate these works?”²¹⁷

To address the issue of education, the Inquiry has utilised its experience upon the evidence given to it in order to at least outline the elements which should find their way into such a course.

Before doing so the Inquiry notes that a comprehensive approach to education involving all of the matters set out below will remove the basis of many of the ill-informed and uninformed criticisms made of possible recommendations.

The recommendations the Inquiry is proposing are not overly complex and are intended to;

- 1) overcome the gaps in the business accounting and administrative education by engaging what are otherwise very competent members of an important industry; and
- 2) explain carefully to all members of the industry the effect of the new recommendations if they are accepted wholly or partly by Government.

The importance of education

The widespread acceptance of the benefits of professional and trade education often leads to a rather superficial approach on the part of Inquiry such as this when making recommendations. There is a considerable temptation to simply intone the requirement for education and leave the matter there rather than go more deeply into the requirement and, in particular, the way in which these requirements will be met.

The importance of the education function cannot be overstated. The Government response to the recommendations of the security of payment working group in Victoria in December 2004 included the following statement:

“The supplementary (non-legislative) actions recommended by the Working Group are also substantial. It was strongly recommended that more educational materials, training and advice should be provided to the industry to generate greater awareness and understanding of the Act.”²¹⁸

The Inquiry has spent time in the consideration of a somewhat prescriptive education approach – one that will not simply get lost in the electronic mist of the files in the offices of public servants or lost in the paper of those who still prefer to work with hard copies. The approach is intended to be one that can play a role as a foundation in Australia and one which

²¹⁷ Witness to Inquiry.

²¹⁸ Victoria Building Commission, *Government Response to the Recommendation of the Security of Payment Working Group, 2004* (2004 Victorian Government Response), p. 3.

will be applied with the necessary changes being made, in different states and territories. It should be an organic model of a kind that can be developed from year to year with changes in practices, changes in legislation and other developments and innovations which require continual monitoring.

The building and construction industry is not a part of the world which can be isolated from the need to understand modern business practices and the Inquiry has discerned no inclination on the part of the witnesses who gave evidence to suggest that that should be the case.

Approaching education

The overall goal of the Inquiry's recommendations is to recommend an approach that will 'bring the bottom to the top rather than the top to the bottom'.

These recommendations are designed to be a friendly aid to the progression of growth and sustainability throughout the industry. The education approach put forward and examined below, is intended to be the recurrent spark for continuing professional development which lies at the heart of the recommended licensing requirement and is an essential plank in the structure of the Building and Construction Commission recommendation.

One of the Inquiry's themes in developing the education response has been the promotion of 'industry self-help' at no cost to Government. It is suggested that this could be achieved with the following measures in place.

Establishing a 'Building and Construction Commission'

The Inquiry has made a recommendation for the establishment of a New South Wales Building and Construction Commission (the 'Commission'). Similar examples of such a body include the Queensland Building Services Authority, the Victorian Building Commission and in Hong Kong the Construction Industry Council.

The Commission would be given power to assign education accreditation to those organisations which are either currently providing education within the industry or those organisations which aspire to do so.

Further, the Commission would be charged with the responsibility of developing the syllabus for each of these courses and ensuring that the syllabus remains a standard one and is taught to the requisite standard by each of the accredited organisations.

In this way, the education function can continue to be outsourced and the cost to Government can be reduced or kept at a low level.

Mandatory education requirements tied in with licensing

To assist in bringing the financial education levels of subcontractors up to a minimum level, the Inquiry is recommending mandatory education requirements for all participants in the industry that will then tie in with the proposed licensing regime. By doing so, it is proposed that subcontractors and their businesses will be in a better position financially, as well as having the necessary skills required to grow their business.

What should be covered?

Legislation

It is essential to have a good understanding of the relevant legislation that regulates work in both the residential and commercial spheres. Relevant legislation in NSW includes (not exhaustive):

- *Building and Construction Industry Security of Payment Act 1999*
- *Building and Construction Industry Security of Payment Regulation 2008*
- *Contractors Debts Act 1997*
- *Home Building Act 1989*
- *Home Building Regulation 2004*
- *Personal Property and Securities Act 2009 (Cth)*

Without this knowledge and awareness, the remedies available to contractors and subcontractors lie dormant. Legislation enacted to assist subcontractors is of no use to those who are either unaware that it exists or do not know how to access it and use it to their benefit.

The Fundamentals

The Inquiry considers that education on business and management skills should include at least the following modules:

- Contractual obligations;
- Trade specific contractual obligations;
- Supervision;
- Business planning;
- Estimating and scheduling;
- Financial matters and accounting; and
- Legal and risk management.

These should include the following topics:

- Standard forms of contract and how they work;
- The fundamental principles of contracting;

- Critical issues such as latent conditions, time limits, variations, extension of time, liquidated damages and the management of risk in designs;
- Preparation in proper form of progress claims;
- Solvency both from the point of view of the subcontractor itself becoming insolvent, dangers of trading while insolvent and the effect of insolvency of the building contractor upon the subcontractor; and
- Corporations law.

Further, should certain recommendations proposed by this Inquiry be adopted, subcontractors could also be educated in:

- Their rights to be paid (and to pay) within a statutory period of 28 days (whether under contract or under adjudication legislation); and
- The use of trust accounts and the responsibilities of parties associated with its use.

Finally, and perhaps most importantly, subcontractors would be educated in book keeping, accounting, tender preparation, an analysis of the concept of risk and the requirements of the Australian Tax Office.

Ideally these components should be made a compulsory element in a proposed licensing system. As has been said elsewhere in this Report, it seems inconceivable that a builder requires a licence to carry out bathroom repairs in Birchgrove and yet no licence should be required to build a multi-storey building in Macquarie Street in Sydney.

Current education

The logical start of this approach is built upon the existing education requirement in what is known as Certificate IV²¹⁹ in the Building Industry.

This is the starting point for satisfying essential requirements in becoming a licensed residential builder. In addition to demonstrating at least two years relevant industry experience in a wide range of building construction work, applicants must have attained one of the following qualifications or examinations:

1. *Certificate IV in Building and Construction:*

PLUS any of the following:

- *Licence or qualification for Carpentry, Carpentry & Joinery or Bricklaying*
- *Diploma of Building and Construction (Building) including the following units:*
 - *Supervise and apply quality standards to the selection of building and construction materials*
 - *Select and manage building and construction contractors*
 - *Administer the legal obligations of a building and construction contract*

²¹⁹ CPC40110 Certificate IV in Building and Construction

- *Identify services layout and connection methods in medium rise construction projects.*
- *Degree in Civil Engineering, Structural Engineering, Architecture or a Bachelor of Housing from an Australian University.*

2. *Degree in Building, Construction, Construction Management, Construction Economics, Applied Science (Building), or Quantity Surveying from an Australian University.*²²⁰

Another course that would give subcontractors a greater appreciation for contracts is found in Certificate IV in Building and Construction (Contract Administration).

Who offers this education?

The Inquiry has noted during its investigations that organisations such as the Housing Industry Association (HIA), the Master Builders Association (MBA) and the Technical and Further Education Commission (TAFE), among other groups, provide the above educational courses and offer a wide variety of related building courses required for those in the industry.

As the Inquiry has observed above, it is a simple matter to address the Term of Reference requiring consideration of strategies to improve financial management skills in the industry, and ‘conclusively’ provide a general answer along the lines that the kind of education under discussion will contribute to a reduction in some of the industry’s less enlightened practices.

Drawing upon its own expertise and that of those who gave evidence to the Inquiry, the ready availability of material on-line in libraries and from authoritative bodies such as the Institute of Arbitrators and Mediators of Australia, HIA or the MBA for the purposes of devising one or two examples of the kind of courses that should be made compulsory to members entering the industry, the Inquiry wishes to make some suggestions about the kind of education to be offered.

The approach to the construction of such courses is not ‘*once over lightly*’. It involves a detailed syllabus in the first instance and then the requirement for continuing professional development (CPD) points to be acquired each year, similar to the system in place for solicitors and other practising professional occupations. This again is similar to the Queensland model which has worked so successfully.

Other areas

Other areas of education such as Occupational Health and Safety courses were noted by the Inquiry to be delivered by groups such as the Construction, Forestry, Mining and Engineering Union (CFMEU).

²²⁰ NSW Fair Trading website accessed 16 November 2012.

The provision of support for the use of such groups for educational purposes cannot be understated given they not only contain a vast and experienced knowledge base, but they are often the first port of call for subcontractors in the industry's various sectors and can assist in providing a well-rounded education and solid foundations for running a business.

Educating the commercial sector

In relation to entry into the commercial building sector, applicants must be able to demonstrate at least the level of competence required of those in the residential sector.

Without intending to disparage the contents of the Certificate IV education structure there are a number of important areas where the course needs development. Naturally those who devise this helpful TAFE course did not intend it to be the kind of course that would be as detailed or all-embracing as that which the Inquiry has in mind. Nevertheless the material in the course lends itself neatly to augmentation along the lines of the Inquiry's recommendations.

To take one simple example which is not dealt with in the course at least so far as the subject headings provide a clear indication of course content, one of the important elements in commercial construction is the awareness and ability to use critical path network programs. That should be an element in the course at least taking those who intend to participate in commercial construction through the details of a *prima vera* system of construction programming.

Before fleshing out the Certificate IV requirements, two key propositions should be advanced. The education program should:

- i) rest hand in glove with the licensing requirements and is not to be cut adrift from those requirements; and
- ii) be of a similar structure to the existing Certificate IV with a CPD program which again will be central to the renewal and continuation of licensing status.

On top of those observations the Inquiry believes that there is a desired consistency to be obtained in those cases where there already is a firm foundation for such an education program.

It is the firm view of the Inquiry that the status, prestige and pride of the industry will be developed by the maintenance of a course such as that outlined by the Inquiry. It was therefore somewhat disheartening to notice the Stateline program on Friday 9 November 2012, which highlighted the difficulties encountered by the TAFE education system.

The point has often been made by politicians that there are many honourable worthwhile and remunerative employment opportunities in the community for those young men and women who do not decide to go to university. In the last several years earnest attempts have been

made by many in positions of influence in the community to emphasise to young people that their life has not hit a barrier if they for any reason do not go to a university.

The recommendations of the Inquiry concerning the need to upgrade the education requirements in the building and construction industry are consistent with this notion and they are consistent with the work of some tertiary institutions in Australia which have developed their own degree courses in disciplines of this kind.

It is no answer to a law reform recommendation to say that in the twenty first century the members of the industry or industry sector to whom the reform is directed do not have enough ‘sophistication’, ‘education’, or familiarity with financial and administrative concepts to be able to manage their own affairs. Such an approach is paternal, pompous and wrong. In today’s modern world, for the most part, all that a builder requires to access the educational material of the kind that this Inquiry recommends is a desk, a chair and a computer.

Putting it together

There is a proliferation of material that would easily satisfy the essential components listed above, with much of it already provided by existing organisations and associations.

Given their placement within the industry at present, the Inquiry recommends that the MBA together with the HIA and the Institute combine their efforts to prepare a completely new course program from the ground up that encompasses those important aspects to the industry that are required by all its participants, which ideally should be conducted by those who are best qualified to do so. Participants in the course would pay a fee to the association or organisation providing the education which would become an essential pre-requisite to obtaining a licence in the industry.

Continuing practical/professional development and licensing

The Inquiry has made a further recommendation that there needs to be mandatory continuing practical/professional development for industry participants. This is both a commitment to personal development as well as to the building profession.

The benefits of this system are obvious as subcontractors, contractors and principals will be kept up to date on the latest news in the industry. It will also form a compulsory requirement of the recommended licensing regime to ensure that all licensed participants remain financially viable for the purposes of construction work.

Among examples provided to the Inquiry on the types of topics presented include a:

- Paper prepared by Clayton Utz, “Contractor Insolvency in the Construction Industry, Key Issues for Principals and Head Contracts” dated August 2012. This work has

already been carried out but of course the availability of material of that valuable character will not be known to 99% of participants in the industry.

- A construction industry insolvency presentation by the insolvency specialists Korda Mentha prepared by David Winterbottom and dated 29 August 2012.
- A helpful paper by David Cowling, Narelle Smyth and Frank Bannon at Clayton Utz dated August 2012, “Reconstruction and Major Projects”.

Examples from the Queensland Building Services Authority

On the basis that it is often better and more productive to stand on the shoulders of others instead of re-inventing the wheel in various forms, the Inquiry has paid close attention to the delivery and components of education in other states, such as Queensland’s Building Services Authority (‘BSA’).

The BSA has prepared a useful document “Want to get paid quicker?” This of course deals with the *Building and Construction Industry Payment Act 2004* in Queensland and for that reason great care should be taken in applying it to New South Wales. It will of course still be relevant to those builders who are mainly based in NSW and who work across the NSW/Queensland border.

The information kit can be amended so as to be made applicable specifically to New South Wales.

There is also the resource entitled “Getting it Right the First Time: a plan to reverse declining standards in project design documentation within the building construction industry” put together by Engineers Australia.²²¹

As part of its work, this Inquiry has attempted to draw available educational material together to look at what components could be considered for an all-encompassing educational program that could be of use in decreasing the number of construction industry insolvencies in NSW.

That is not the purpose of referring to it, however, in the Inquiry report. The purpose is essentially to demonstrate that there is already a considerable amount of good quality material available upon which the designers of the new program the Inquiry proposes should be established may rely as a commencement base.

Practical business training

The BSA, in line with its licensing regime that seeks to ensure a licensee is stable not just in trade but also in business, offers a range of topics as part of its ongoing training scheme, including the following:

²²¹ Engineers Australia, Queensland Division Task Force, October 2005

- **The Building Game**, Successful Business Strategies Workshop
 - Teaches builders about their profit/loss statements, managing risk, identifying early warning signs that their business is in financial trouble.
 - The Workshop topics include:
 - Using Financial Statements to Assess a Business's Financial Health
 - The Trading Account
 - Profit and Loss Statement
 - Break-Even Point
 - The Balance Sheet
 - My Business is Not Travelling Well! What Can I Do About It?
 - Estimating direct labour costs
 - Estimating business overhead costs
 - Supervision, re-work and wastage
 - Marketing
 - Financial Monitoring
- **'Better Building' Shows**
 - Shows/seminars, helping builders discover ways to improve planning, marketing, estimating, supervision and management skills and help ensure the success of [the builder's] business.
 - Topics presented at the shows include:
 - Contractual Obligations
 - Trade Specific Contractual Obligations
 - Business Planning
 - Supervision
 - Business Planning
 - Client Relations and Marketing
 - Estimating and Scheduling
 - Financial Matters and Accounting
 - Legal and Risk Management

These training practices work much the same way as continuing practical development courses as they essentially keep the licensee's head in areas that require just as much attention as the practical side of the business.

Education

The educational components required for obtaining a licence in the various categories of the Queensland scheme are located in the *Queensland Building Services Authority Regulation 2003*, Schedule 2.

Like the proposed Commission for NSW, the BSA does not offer educational courses such as certificates, diplomas or degrees, but it does recommend various accredited agencies. Two of these providers are the Housing Industry Association and the Master Builders Association

Queensland. Both associations offer accredited courses in Certificate IV in Building and Construction.

The BSA also has links to a number of associations/groups that offer approved Managerial Courses.

Training of adjudicators

It is a recommendation of this Inquiry that if the minimum educational levels of industry participants are going to be raised, it is also important that those responsible for determining disputes regarding funds or works are equally (if not more) qualified as well.

The Australian President of the 'Institute of Arbitrators and Mediators of Australia' (the 'Institute') and the Chairman of the NSW State Chapter has informed the Inquiry in response to questions, that the Institute stands ready, able and indeed eager to assume an education responsibility for adjudication and mediation at no cost to Government.

The Institute is a venerable body dedicated to providing a public service and whose members have for decades presented lectures, written papers and books, and provided mentoring facilities, all for the purposes of providing an education which is so clearly needed. Its members include judges, former judges, Queens Counsel, barristers, solicitors, quantity surveyors, engineers, architects and builders. Its reputation for fairness, objectivity and competence is unquestioned. It is, in the opinion of the Inquiry, the expansive history that allows the Institute to be able to draw upon and offer its accumulative wisdom and expertise.

From the evidence provided, the Inquiry is firmly of the view that there are existing excellent facilities which can be used for the purpose of promoting education.

The Statutory Construction Trust

Recommendations: Terms of Reference 3(f):

“Consider legislative or other policy responses that can be taken to minimise the incidence and impact of insolvency in the industry, including the effectiveness of trust arrangements in protecting sub-contractor payments retained by a lead contractor or principal”

An effective form of protection against the loss of one or more progress payment claims paid by the principal to the head contractor and not paid out to the subcontractor, is what is known as the statutory construction trust. Some of the literature in the United States mixes that concept with the ‘constructive’ trust. The Report has nothing to say about the question of constructive trust²²² which is an entirely different creature to the statutory construction trust.

There is no question that the statutory construction trust is fully effective in protecting subcontractors against the loss of progress claims paid by the owner to the head contractor and lost in the event of the head contractor’s insolvency.²²³

Considerable support for the statutory construction trust

The construction trust has a long and useful history in the provinces of Canada (except for the provinces of Newfoundland, Prince Edward Island and Quebec and the territories of Nunavut, the Northwest Territories and the Yukon).

Those common law provinces in Canada where the construction trust is on the statute books are:

²²² Except incidentally in its examination of the rule in *Barnes v Addy* (1873-74) LR 9 Ch App 244.

²²³ As Kent Collier in his article entitled “*The Nuts and Bolts of Bankruptcy, Trust Funds, and the Construction Industry: Building a Solution for Subcontractors Nailed with an Unpaid Bill*” (2004-2005) 21(2) *Emory Bankruptcy Developments Journal* 623 confirms (at 637):

A subcontractor who is trying to get money from a bankrupt contractor before other creditors wants money held by the contractor for his benefit to be characterized as a trust. He hopes that through the label of a trust, the money will not become part of the bankruptcy estate, and he can take the money, once due, as a beneficiary of the trust. Furthermore, the subcontractor may receive this money despite the ongoing bankruptcy and possibly make the debt non-dischargeable if the trust does not completely cover the debt.

Canadian province	Relevant construction trust legislation
Alberta	Builders' Lien Act R.S.A. 2000, c. B-7, section 22
British Columbia	Builders' Lien Act S.B.C. 1997, c. 45, sections 10 to 14
Manitoba:	The Builders' Liens Act R.S.M. 1987, c. B91, sections 4 to 9
New Brunswick	Mechanics' Lien Act R.S.N.B. 1973, c. M-6, section 3
Nova Scotia	Builders' Lien Act R.S.N.S. 1989, c. 277, sections 44A to 44G
Ontario	Construction Lien Act R.S.O. 1990, c. C.30, sections 7 to 13
Saskatchewan	Builders' Lien Act S.S. 1984-85-86, c. B-7, sections 6 to 21

In America, the construction trust is also provided for in the following states:

American state	Relevant construction trust legislation
Arizona	Ariz. Rev. Stat. section 33-1005
Colorado	Colo. Rev. Stat. Ann. Section 38-22-127
Delaware	Del. Code Ann. Tit. 6, section 3502
Illinois	770 ILL. Comp. Stat. 60/21.02
Maryland	Real Prop. Sections 9-201 <i>et seq</i>
Michigan	Com. Laws. ss 570, 151 <i>et seq.</i> (1961)
Minnesota	Minn. Stat. Ann. section 514.02 (2003)
New Jersey	N.J. Stat. Ann. section 2A:44-148 (West 2004) (applies to public works) N.J. Stat. Ann. sections 2A:29A <i>et seq</i> (governs private parties who have forwarded money toward the purchase of a dwelling house.)
New York	Lien Law sections 70-79-a
Oklahoma	Stat. tit. 42, sections 152 and 153 (2004).
South Dakota	Codified Laws section 44-9-13 (2004)
Texas	Tex. Prop. Code Chapter 162
Vermont	Stat. Ann. tit. 9, section 4003 (applies to contractors and subcontractors)
Washington	Rev. Code section 60.28.010 (2004)
Wisconsin	Stat. section 779.02(5) (2003) (applies to private projects) Stat. section 779.16 (2003) (applies to public projects)

It can be seen through the references to the literature in the United Kingdom and to the number of states within the United States and provinces in Canada which have construction trust legislation, that the concept of a statutory construction trust has considerable support.

It has not been shown to be vulnerable to a legal attack and the essential elements of the suggested trust mechanism are in conformity with Australian trust law.

The trust: a remedial device with other attributes²²⁴

The construction trust is essentially a remedial device in the sense that it will be called upon to play its important role when the head contractor becomes insolvent.

The trust is significant not only for remedial purposes. The imposition of the trust upon the moneys paid by the owner to the head contractor also has implications in the period prior to any insolvency of the head contractor. The trust exists as a matter of law whether or not there is any necessity to have recourse to it later in the event of a head contractor's insolvency, and also because the terms of the trust forbid the trust money being applied to purposes which are foreign to the trust purposes. For example, purposes which only benefit the head contractor.

Looked at in that way, it is both necessary and important to determine precisely *how* the trust funds might be utilised in the period prior to them being paid out to the subcontractor – a matter which is dealt with in this Report.

The trust works

The Cole Royal Commission referred to the use of the construction trust as a means of protecting subcontractors.²²⁵ It looked at the trust in the context of similar circumstances which have given rise to the present Inquiry and for similar reasons concluded in effect that there was no legal obstacle to deployment of the trust as a means of protecting subcontractors. That said, the Cole Royal Commission did not make an outright recommendation either for or against the use of a trust fund mechanism. The Royal Commissioner made the following statement in his concluding comments on the issue:

“In not recommending the wider adoption of a deemed trust model, the Commission should not be taken to be recommending against that model. On the contrary, it appears to me that many of the objections to the deemed trust model may be overstated. The fact is, however, that industry opposition to

²²⁴ See also the full list of advantages set out in this section.

²²⁵ 2003 Cole Report, vol. 8, ch. 14, p. 245, para [80].

trusts is so entrenched that any recommendation in relation to them would very likely be vigorously opposed, and debate in relation to it would be likely to be protracted. The Commission has therefore chosen to focus upon reform recommendations to improve security of payment that have better prospects of being accepted and implemented.”²²⁶ (emphasis added)

Despite an acknowledgement that there would be “*opposition... so entrenched*”²²⁷ the Cole Royal Commission did not have “*a great deal of evidence to support the views*”²²⁸ that formal trusts are not cost effective.

Indeed, a Western Australian case example referred to later in this section of the Report serves to illustrate the protection available to subcontractors through the use of a trust account by the head contractor and the complementary benefit of faster payments.

The present Inquiry is required, by its Terms of Reference, to go further in its consideration and analysis of the possible utility of a simple trust device to protect the rights of subcontractors.

But before doing so, it is perhaps useful at this point to be reminded of the role of the subcontractor in the building and construction industry.

The role of the subcontractor in the industry

The most important of all of the Inquiry’s findings is that as a result of changes in the way contractors carry on their business, there has been a major shift away from the older style of the general contractor which employed a significant workforce consisting of several trade groupings in addition to executive, administrative and clerical staff required for the operation of any contracting business.

This new industry model was clearly recognised by the Cole Royal Commission, which concluded that:

“(w)hile the large contractors subcontract most of [the] work to smaller businesses.....large contractors control a substantial part of the industry’s output and cash flow. The shape of the industry is that of a flattened pyramid.....”²²⁹

²²⁶ Ibid, p. 250 at para [109].

²²⁷ Ibid.

²²⁸ Ibid, p. 249 at para [102].

²²⁹ 2003 Cole Report, vol. 3, p. 60.

This conclusion was universally acknowledged by all witnesses who gave evidence to the Inquiry upon the subject of the industry's current characteristics.

From this finding, critical conclusions follow concerning the manner in which the principal's payments to the head contractor should be treated. Particularly this is so where those payments include substantial amounts of money referable to work carried out by the subcontractors.

One question: what is fair?

The most compelling reasons in support of some kind of trust arrangement are those borne out of fairness and recognition that in reality, the head contractor is being paid for the most part for work carried out by others – that is, subcontractors. It is recognised by the Inquiry that the extent to which the head contractor takes on the form of a project manager varies from job to job and it is also recognised that in some cases, the obligations and the duties of the head contractor are more recognisable as those of project managers.

Once it is established and acknowledged that such progress payments made by the principal to the head contractor largely include money in respect of subcontractors' progress claims made to the head contractor, then the justification for an intervention to protect the rights of the subcontractors who have executed most of the work for which the owner/principal has paid the head contractor is, in the view of the Inquiry, incontestably made out.

The present law

Although the subcontractor's claim to be paid legitimate progress claims out of the payments made by the principal to the head contractor rests upon a strong moral basis and is what any fair minded observer would expect to take place, it is clear that the law does not recognise any right to such moneys *in rem* and has contented itself to this point with confining the subcontractor to its rights in contract against the head contractor. Unless there is some kind of statutory intervention, the subcontractor has no entitlement to make any claim directly against the principal or against the fund itself *in rem*. It is confined to its contractual rights against the head contractor.

The three-level relationship in which only the two adjoining parties are in contract with each other characterises the construction industry and determines the fate of the subcontractor. In this relationship, which shows no signs of changing in the industry, the principal does not contract with, and has no dealings directly with, the subcontractors. Its contract is with the head contractor.

For its part, the subcontractor enters into a contractual relationship with the head contractor. In the rather unusual situation in which the subcontractor finds itself, even though the “pay when paid” condition has been abolished,²³⁰ the subcontractor remains entirely in the hands of the head contractor to whom the subcontractor has forwarded its progress claim, all of this is in the expectation that that progress claim will be passed on by the contractor in its own progress claim to be submitted to the principal and be paid as a result by the head contractor.

The industry has not yet reached a point where head contractors acknowledge their freestanding obligation to pay the subcontractor’s progress claim in a completely unqualified manner. There remains a de-facto pay when paid mentality. The mantra of “cash flow” too often obscures a clean and simple appreciation of the right of the subcontractor to be paid.

In the most common form of building and construction framework, the starting point is the long-standing legal principle that the relationships between the three members of this structure are to be governed by privity of contract. Thus, where the head contractor is being paid a sum of money due under a progress claim from the principal, which includes an amount for the work of subcontractors, the contractor does not receive and thereafter hold that portion of the money then due and owing to the subcontractor, as trustee for the subcontractor.

In order for a trust to arise in these circumstances, more needs to be done. One must be able to discover an intention to create a trust, a trustee who holds specific trust property and a beneficiary. They are the essential elements necessary to create an express trust. It is not at all difficult to convert the traditional payment of a progress claim which includes subcontractors’ work for a head contractor into a valid express trust.

That can be done either by agreement between the parties or as a consequence of a statutory intervention.

Trusts by agreement: the trust approach is often chosen by the parties

In a practical sense, owners, contractors and subcontractors have commonly chosen to utilise construction trusts in their contracts. In the Inquiry’s view this serves to demonstrate legal, professional and industry recognition of the utility of the trust. The utilisation of trust mechanisms as part of the formal payment structure within the building and construction industry is also becoming more common.²³¹

²³⁰SOPA, s. 12.

²³¹ See the Project Bank Account and GC21 references later in this section of the Report

AUSTRALIA:

The Australian Defence Force Managing Contractor Contracts

Trusts of this nature were first used in Australia on a volunteer basis in defence contracts. In his recent presentation paper “How Suite It Is”, Professor Doug Jones AO explained the use of ‘trust deed’ provisions in Australian Defence Force contracts.

“One of the key concerns facing Defence in 1992 was the potential insolvency of its contractors and the impact on security of payment for subcontractors and the completion of its projects. This was exacerbated under managing contractor delivery, under which the use of subcontractors was mandated for all reimbursable work.

To address this risk, a "trust deed" mechanism was conceived for inclusion in the Managing Contractor Contract, which aimed to:

- (i) ensure timely cash flow and security of payment for subcontractors; and*
- (ii) protect Defence and subcontractors from the repercussions of any insolvency of a managing contractor.*

This mechanism (which pre-dated the first security of payment legislation in NSW in 1999 and is still in use as at 2012) requires the managing contractor to establish a trust account for receipt of monies paid by Defence to the managing contractor on account of work performed by subcontractors. All monies paid into the trust account are held on trust by the contractor for the benefit of the subcontractors and may only be distributed to the subcontractors.”²³²

The Inquiry has heard evidence from a number of head contractors who did not agree that the trust deed was an effective mechanism.²³³ However, one head contractor who gave evidence before the Inquiry confirmed that where his company had been engaged under Managing Contractor contracts with Defence and had been required to establish a trust deed for subcontractor payments, there had been no issues for his business.²³⁴ In the view of the Inquiry, a sensible, matter-of-fact adjustment to the trust of this kind will be commonplace if the construction trust was legislated.

²³² Jones, D., Clayton Utz, “How Suite It Is”, Paper presented at the ADM Defence Support Service Summit, 7-8 August 2012, Melbourne, p. 10.

²³³ This approach is dealt with in detail later in this Report

²³⁴ Witness to the Inquiry

Retention moneys in trust

In NSW, there are some standard forms of contracts that contain trust account type clauses which provide that any portion of security which is cash or retention moneys shall be held in trust for the party providing it, until the principal or the head contractor is entitled to receive them.

For example, in the NSW “GC21 (Edition 2) – General Conditions of Contract”, clauses 33.7 to 33.9 relevantly provide:

33. Security

Cash Security - Subcontracts

The Contractor may require Subcontractors to provide security for Subcontracts in the form of cash security, retention money or unconditional undertakings to pay on demand provided by financial institutions on the Subcontractor’s behalf.

...

- 33.7 If the Contractor receives or retains security in cash or converts security to cash under any of its Subcontracts, that security is held in trust by the Contractor from the time it receives, retains or converts it.
- 33.8 If the Contractor receives payment under the Contract for, or on account of, work done or Materials supplied by any Subcontractor, and does not pay the Subcontractor the whole amount to which the Subcontractor is entitled under the relevant Subcontract, the difference is held in trust for payment for the work done or Materials supplied.
- 33.9 The Contractor must deposit all money it receives in trust, as described in clauses 33.7 and 33.8, into a trust account in a bank selected by the Contractor no later than the next Business Day, and:
- (1) the money must be held in trust for whichever party is entitled to receive it until it is paid in favour of that party;
 - (2) the Contractor must maintain proper records to account for this money and make them available to the Subcontractor on request; and
 - (3) any interest earned by the trust account is owned by the party which becomes entitled to the money held in trust.

By this single arrangement, both a retention trust is established together with the equivalent of a construction trust. The Inquiry notes that there has not been any significant opposition to such contractual provisions.

Where trusts are used to overcome a project crisis

There are other cases which the Inquiry has heard of where the parties have not elected to employ a construction trust at the time of entering into the construction contract but have utilised it as a solution to pressing difficulties in the project which had been caused by irregular, unreliable and spotty payment practices adopted by the contractor to the disadvantage of the subcontractors.

Below are two recent examples: a “Western Australian case example” and the “Reed Constructions Law Courts example;”

A Western Australian example²³⁵

This Western Australian case example serves to illustrate two points of considerable interest. The use of a trust account facilitated:

- faster payments to subcontractors; and
- protection for the subcontractor against the loss of progress payments in the event of the insolvency of the head contractor.

The crisis

After a period during which the subcontractors had repeatedly been paid late by the head contractor, the subcontractors came together and formulated a plan to picket the site in protest against the late payment of their claims, hoping by that means to pressure both the principal and the head contractor to take steps to correct the problem. Those steps did not eventuate and the principal therefore decided to step in.

The Trust solution

The means by which the principal did so was to inform the head contractor that from that time onwards, the principal would pay the head contractor’s certified progress claims into a specifically created bank account for which there were two signatories - the head contractor and the principal.

The head contractor would retain responsibility for payments which were, in effect, divided into two categories: (i) payments to itself and (ii) payments to the subcontractors.

A short side deed, setting out the purpose of the joint account and stipulating that the principal itself was not a trustee, had not made itself liable to a direct claim by the subcontractors and otherwise keeping the principal at arm’s length from the subcontractor relationship, completed the arrangement.

In that way the principal did not otherwise involve itself in the contract administration and at the same time ensured that the subcontractors who were carrying out the lion’s share of the work were kept happy. The solution was both inexpensive and effective.

²³⁵ Yet it was more complicated than the Inquiry’s proposed statutory construction trust according to the evidence of one of the solicitors involved in the matter.

What is immediately apparent from this Western Australian example is that the solution to the problem required the principal to obtain the agreement of the head contractor to institute and operate the joint bank account. The Inquiry has not sighted the agreement between the principal and the head contractor, however it has assumed that all of the remedial provisions which were successfully put into operation were not contained in existing provisions in the contract and that the contract did not itself contain a provision which enabled the principal to insist upon the agreement of the head contractor to the cause proposed.²³⁶

An Irony: Reed Constructions Law Courts example

The project

This project commenced in June 2007 and concerned the refurbishment/redevelopment of the Law Courts Building in Queens Square Sydney. Under a construction management agreement with the government agency Law Courts Ltd (as Principal - a company jointly owned by the State and the Commonwealth) Reed Constructions Australia Pty Limited (RCA) was appointed as Construction Manager (“the Law Courts Project”). Law Courts Ltd agreed to novate the construction management contract for the Law Courts Project in 2012 to RBG Holdings Pty Ltd, the holding company for the Reed Group.

The Crisis

RCA becomes insolvent.

The Trust Solution

The original construction management contract and novation of the agreement contained provisions which expressly set out the payment regime that was to operate for trade contractors generally. It is of course significant that this was a construction management contract.

As part of that payment regime, RCA (as Construction Manager) was required to establish a Project Account to be operated on trust for Law Courts Ltd (as principal) and from which account progress payments would be made by RCA to the trade contractors.

Despite the widespread adverse publicity given to RCA’s insolvency, the Law Court’s Project has proceeded harmoniously because of the flow of regular and reliable progress payments from the operation of the Project Trust Account.

Ironically, while the insolvency of RCA was one of the trigger points for the establishment of this Inquiry, a project in which a related company was involved, has also provided another successful demonstration of construction trust *in practice*.

²³⁶ The Inquiry is indebted to Avendra Singh, Partner, Colin Biggers & Paisley, for this example.

UNITED KINGDOM:

The Latham Trust Fund Proposal

“In seeking to create a protective mechanism for contractors, the Latham Report recommends setting up a trust account for all construction projects. Under the Latham proposal, the owner would be required to make payments into this account at the beginning of each payment period for the amount due for the next activity schedule. Milestone payment mechanisms are proposed pursuant to which payments would be delivered from the trust fund upon the achievement of pre-ordained milestones or at interim periods. In the event that the contract was based upon the Bill of Quantities method, the owner would have to agree to reasonable payments in advance each month. Interest would be charged on overdue payments in order to deter slow payment.”²³⁷

An expression which is apt to describe what the construction trust is intended to achieve is to *“secure payment routes to contractors and subcontractors.”*²³⁸

In his report, *Constructing the Team*, Sir John Latham proposed a construction trust arrangement which required the client employer, principal, or developer paying money into the trust account at the beginning of each interim payment period, the amount that will fall due at the end of that period.²³⁹

The statutory construction trust proposal recommended by this Inquiry does not involve that kind of advance prepayment by the principal and does not involve the client in any way at all in the trusts lower down. This is a significant aspect of the allocation of risk. Criticisms of the Latham Report Trust Fund Proposal should not be confused with the quite different construction trust proposal which is recommended by the Inquiry.

A simple question – who should carry the risk?

Although the issue is not strictly a legal question, its bare bones must nevertheless be laid out at the threshold - who should bear the risk of the insolvency of the head contractor, or a shortfall in the money available to pay head contractors and subcontractors down the construction chain?²⁴⁰

²³⁷ Reynolds, B., “A Canadian Approach to the Minimisation of Construction Insolvencies”, ch. 5 in Davis R. and Odams, M. (eds), *Contemporary Issues in Construction Law*, vol.1, Security for Payment, 1996, Construction Law Press, Centre of Construction Law & Management, King’s College, London, pp. 117-162 at 154.

²³⁸ Jenkins, J. “The Latham report trust fund proposals” (1995) 11 CLJ 262.

²³⁹ *Ibid*, p. 263.

²⁴⁰ *Ibid*, p. 264.

The Inquiry has firmly concluded that the moral reality of the construction industry provides the answer to that question. In circumstances where the Inquiry has found it to be the case that subcontractors carry out more than 80% of the work, then there can be no question that subcontractors should not bear the risk of an insolvency of the head contractor standing above them in the contract chain. When there is a statutory construction trust, that risk is removed.

Of course one of the additional benefits of the construction trust proposal is that it provides protection to the principal from the insolvency of the head contractor in at least two ways.

Firstly, it prevents the principal having to pay the amount owing to the subcontractor twice. That is, once to the head contractor who becomes insolvent and then once more to the unpaid subcontractor if it is intended to keep the subcontractor happy and working on the job.

Secondly, it will ensure a smoother transition in order to solve the difficulties involved for the principal when endeavouring to replace the insolvent contractor.

One of the main criticisms of the Latham Report Trust Fund Proposal in the United Kingdom was that:

“...the prefunding of payments will reduce cash flow and push up financing cost for the client. Such increased cost will inevitably be passed on, in part, if not in full, to the contractor.”²⁴¹

In the delicate exercise of the allocation of risk and freedom to choose, in the words of Jenkins:

“the contractor may prefer to face the risk of the client’s insolvency rather than incurring the rises which will eat into any profit margin available on the construction project. The protection is, in any event, available only for the duration of each interim payment period and this may be another fact which would encourage a contractor or subcontractor to dispense with the proposal.”²⁴²

Considerations of that kind do not affect the proposal recommended by the Inquiry.

²⁴¹Ibid. p. 264, para. 4.

²⁴²Ibid. 264, para. 4.

As Jenkins points out²⁴³ the Latham Report did not recommend the imposition of a trust fund in respect of moneys that became due to the contractor from the principal.

The Project Bank Account in the United Kingdom

Important recent developments in the United Kingdom demonstrate that the trust concept has been given practical form by the utilisation of the so called Project Bank Account (PBA) method of contract administration. The fundamental parts and operation of PBAs were comprehensively set out in the Inquiry's Discussion and Issues Paper 2012 and comments actively sought.²⁴⁴ The Paper in setting out how the PBA system works included the following:

What is a PBA.....

A PBA is a ring-fenced bank account from which payments are made directly and simultaneously to a lead contractor and members of the supply chain. The PBA must have trust status which means that the monies in the account can only be paid to the beneficiaries – the lead contractor and supply chain members. The account is held in the names of trustee who are likely to be the Client and Lead Contractor under the Dual Authority approach (but members of the supply chain could potentially also be trustees). While under the “Single Authority” approach the lead contractor is the sole trustee, this does not materially alter the protection offered in terms of security of funds, certainty of payment or the operation of the PBA.”²⁴⁵

Simply put, one may describe it as a mechanical application of the statutory construction trust although in the case of the PBA, the trust is established by a short and simple side trust deed rather than as a creature of statute.²⁴⁶

Responses to the Inquiry's Discussion and Issues Paper on PBAs

In the responses to the Inquiry, there was a significant degree of support for the concept of ring fencing payments for subcontractors through the PBA system or similar mechanism.

However a number of contractors who responded to the Inquiry's invitations to give evidence and make submissions believed that implementing PBAs would be detrimental to the NSW construction industry. For the most part this criticism was general in nature. The Inquiry sought comment from the United Kingdom Cabinet Office on the

²⁴³ Ibid.

²⁴⁴ Inquiry Discussion and Issues Paper, pp. 48-51.

²⁴⁵ UK Cabinet Office. “Government Construction A Guide to the implementation of Project Bank Accounts (PBAs) in construction for government”, 17 May 2012, p.4.

²⁴⁶ Inquiry Discussion and Issues Paper, October 2012, p. 48-49.

types of criticisms being levelled at the use of PBAs. The UK Cabinet Office response to each of the criticisms in italics is provided below:

Trust accounts are not suitable to the Australian market

“If in Australia you do have situations (as we have here), where money does not cascade sensibly down the supply chain, which starve lower tiers of cash.....(the UK Cabinet Office does not) see why trust accounts should not be suitable. The UK construction industry is made up of some 250,000 companies the vast majority, something like 99% SMEs..... would not agree that the subcontractor base is made up of 'large well set up and educated subcontractors'.”

The PBA system does not address matters relating to under bid projects.

“A trust account will NOT resolve issues in under bid projects - nothing will - however what it will do is make sure that if any member of the supply chain within the trust account goes bust because they have under bid, money they owe down the line within the trust account is safe if they become insolvent.”

PBAs are onerous, administratively burdensome, costly to all parties

“Not true, feedback from departments who are using them is that administration and cost (is) minimal”

Concerns also raised that it could lead to increased supplier failure risk, deterioration in contractors' ability to manage the supply chain, reduction in competition in the industry and reduction in investment in the industry.

“.....no impact on contractual arrangements and ability to manage supply chain.”

PBAs may actually increase the risk of insolvencies in the construction industry as Main Contractors will have cash removed from their balance sheets, weakening the balance sheets of the largest contractors in the industry.

“No cash is reduced from balance sheets. Money cascades faster to those that it is due.”

PBAs will add an administrative and therefore cost burden on to Main Contractors. This will increase pricing and reduce the competitiveness of the local construction industry.

“Added costs minimal – overall savings in the region of 2.5% - no impact on competitiveness.”

They do not provide any solution to the problem of client insolvency

“True, but as PBAs are being implemented by government clients, insolvency NOT an issue.”

A PBA will not ensure that correct payment is made nor will it eliminate payment disputes.

“PBAs are only a vehicle for payment (of) agreed amounts so any disputes about quantum will be sorted in ‘normal’ way and will provide transparency.”

Legal issues relating to the creation of trusts and insolvency and property law issues have apparently not yet been resolved.

“No issues raised in the £1.1bn signed up to date.”²⁴⁷

The criticisms of the PBA system do not correspond to the actual experience in the UK. As the reader will see, these criticisms, so easily addressed above by the UK Cabinet Office, are of the same ilk as those raised in Australia in previous inquiries and reports on security of payment issues. This Report addresses each criticism in detail. The Inquiry has noted that the NSW Government among other reform options it is considering, is now looking closely at the UK experience.

NEC Engineering and Construction Contract

The English form of contract NEC2 Engineering and Construction Contract (2nd edition, November 1995) (NEC2) contains a trust fund provision which implements the recommendations made in the Latham Report on that subject.

In its recommendations on the most effective form of conditions in “A Modern Contract”, the Latham Report recommended that a modern form of contract should provide “for secure trust fund routes of payment.”²⁴⁸

To bring this recommendation into play, the Latham Report specifically suggested that the English form of contract New Engineering Contract (NEC) be amended such that “provision should be made, as a Core Clause, for a secure trust fund to be arranged, into

²⁴⁷ UK Cabinet Office advice.

²⁴⁸ See the 1994 Latham Report, p.37 at para 5.18 (10).

which the client deposits payments for each milestone, activity schedule or interim payment period before the commencement of the relevant period. This will provide much greater confidence for contractors and subcontractors.²⁴⁹

Accordingly, NEC2 included an Option V (Trust Fund) clause which states:

Option V : Trust Fund

Defined terms V1

V1.1

- (1) The Trust Fund is a fund held and administered by the *Trustees*.
- (2) The Trust Deed is a deed between the *Employer* and the *Trustees* which contains the provisions for administering the Trust Fund. Terms defined in this contract have the same meaning in the Trust Deed.
- (3) The Initial Value of the Trust Fund is an amount which is the total of the Prices at the Contract Date multiplied by 1.5 and divided by the number of months in the period between the Contract Date and the Completion Date.
- (4) Insolvency of an individual occurs when that individual has
 - presented his petition for bankruptcy,
 - had a bankruptcy order made against him,
 - had a receiver appointed over his assets, or
 - made an arrangement with his creditors.
- (5) Insolvency of a company occurs when it has
 - had a winding-up order made against it,
 - had a provisional liquidator appointed to it,
 - passed a resolution for winding-up (other than in order to amalgamate or reconstruct),
 - had an administration order made against it,
 - had a receiver, receiver and manager, or administrative receiver appointed over the whole or a substantial part of its undertaking or assets or
 - made an arrangement with its creditors.
- (6) The Beneficiaries are the Contractor and
 - subcontractors,
 - suppliers of the Contractor,
 - subcontractors of whatever tier of a Subcontractor and
 - suppliers of whatever tier of a Subcontractor or of his subcontractors who are employed to Provide the Works.

²⁴⁹ Ibid, p.39 at para 5.20 (2).

(7) A Trust Payment is a payment made by the *Trustees* out of the Trust Fund.

Trust Fund V2

V2.1 The *Employer* establishes the Trust Fund within one week of the Contract Date.

V2.2 The Trust Fund is established

- by the *Employer* making a payment to the *Trustees* equal to the Initial Value or
- by the *Employer* providing the *Trustees* with a guarantee of the Initial Value, payable to the *Trustees* on their first written demand, given by a bank or other financial institution acceptable to the *Trustees* or,
- if the *Employer* is a Government department or other public authority in the United Kingdom, by the *Employer* entering into irrevocable undertakings with the *Contractor* and the *Trustees* to pay the *Trustees* promptly on demand such amounts as they request for
 - Trust Payments and
 - Their fees and expenses for administering the Trust Fund.

V2.3 The *Contractor* informs his suppliers and his Subcontractors of the terms of the Trust Deed and of the appointment of the *Trustees*. He arranges that Subcontractors ensure that their suppliers and subcontractors, of whatever tier, are also informed.

Trust Deed V3

V3.1 The Trust Fund is administered by the *Trustees* in accordance with the Trust Deed. The Trust Deed includes the following provisions.

- (1) If a Beneficiary satisfies the *Trustees*
 - That he has not received all or part of a payment properly due to him under his contract relating to the *works* which was unpaid at the time of the Insolvency and;
 - That the reason for the failure to pay is the Insolvency of the party which should have made the payment;
The *Trustees* may at their discretion make a Trust Payment to the Beneficiary of an amount not exceeding the value of the payment which he has not received.
- (2) If a Beneficiary subsequently receives a payment from another party, in respect of which a Trust Payment has been

made, the Beneficiary passes on that payment to the *Trustees* (up to the value of the Trust Payment). Before making a Trust Payment the *Trustees* may require from a Beneficiary either an assignment of rights or an undertaking with respect to that payment in a form acceptable to them.

- (3) The *Trustees* have discretion to decide the amount and timing of every Trust Payment. They may make a Trust Payment on account or withhold a Trust Payment until they have assessed the total amount of debts owing to a Beneficiary arising out of an Insolvency. They may take into account any claims (including claims by way of set-off) which the party suffering from Insolvency may have against the Beneficiary as well as the likely ability of the liquidator or other administrator of insolvent party to meet the claims of unsecured creditors from funds in his hands.
- (4) If the Trust Fund was established by a payment, the *Employer* maintains the Trust Fund at the Initial Value. If the Trust Fund was established by a guarantor, the *Employer* ensures that the guarantor maintains the Trust Fund at the Initial Value. The *Trustees* notify the *Employer* or the guarantor within one week of making a Trust Payment and the *Employer* or the guarantor restores the Trust Fund to the Initial Value within two weeks of the notification.
- (5) After the *Trustees* have made all Trust Payments, any amount in the Trust Fund (including any accrued interest) is paid by the *Trustees* to the *Employer*. If a guarantee has been provided, it is returned to the guarantor. The *Trustees* do not pay claims from Beneficiaries which they receive after the Defects Certificate has been issued.
- (6) The *Employer* pays the *Trustees* their fees and expenses for administering the Trust Fund.
- (7) The *Trustees* may engage professional consultants to help them with the administration of the Trust Fund and may make Trust Payments for their fees and expenses.
- (8) The *Trustees* hold the Trust Fund on an interest-bearing bank account.

A sample of the Trust Deed referred to in the NEC2 Option V clause was included in Appendix 7 of the Guidance Notes to NEC2.

More recently, in 2008, with the enactment and implementation of the Office of Government Commerce (OGC) Model “Fair Payment Charter” the NEC3 Engineering

and Construction Contract (3rd edition) was amended to include a new Option Z clause – “Z3: Project Bank Account” – which provides for the setting up of a Project Bank Account.

A document entitled “OGC fair payment practices for use with NEC Contracts, June 2008” prepared and published by the NEC panel usefully sets out the terms of the “Option Z3 (Project Bank Account)” clause for inclusion in the NEC3 Contract, together with the Trust Deed and Joining Deed referred to therein. This document, which is available on the OGC website, also sets the OGC’s Model “Fair Payment Charter”, Guidance Notes and a Flow Chart to assist users in understanding and implementing the Option Z3 clause.

This is not the only precedent in the United Kingdom, which provides for secure trust funds. See for example the Specialists Engineering and Construction Procurement System developed by the Electrical Contractors Association, which has in turn been adopted by the specialist-engineering group. The stated objective of the draftsman was the protection of the subcontractor at any tier in the supply chain against the insolvency of its employer.

One of the problems associated with the Latham Trust Fund approach has been the controversial decision in England in the *British Eagle International Airlines Limited VCIE Nationale Air France* decision 1975 to all ER390, 1975 1WLR758 (“the *British Eagle case*”), a decision of the House of Lords.

In that case, it was decided that any attempt made in a private contract to interfere with the *pari passu* principle in liquidation is contrary to public policy and therefore void. The Latham Report recommended the effective abolition of the rule in the *British Eagle case*.²⁵⁰ See generally the new engineering contractor analytical commentary.²⁵¹

The time has come

The present market structure may be the preferred model for the participants, however there is no doubt that a significant number of subcontractor failures are caused by the failure or default of another party in the contractual chain.²⁵²

It is convenient and orderly at this point in the Report to analyse and discuss the way in which the statutory trust has been considered in Australia. At present no Australian

²⁵⁰ See the 1994 Latham Report, p.27, n. 92 and 97.

²⁵¹ McInnis, A., *The new engineering contract: a legal commentary*,²⁵¹ 2001, Thomas Telford, London, pp. 502 – 508.

²⁵² See the 1991 Queensland Government Discussion Paper, paras 1.17 and 1.18 and also the 1998 WALRC Report, para. 3.4.

State or Territory has the construction trust on its statute books. Nor is there any Commonwealth equivalent.

Nevertheless the construction trust discussion has a relatively long history in Australia and that history demonstrates that it has for some considerable time been recognised by prominent lawyers as a legally effective means by which to partially address the problem of subcontractor non-payment.

Failure to pay subcontractors, particularly when the head contractor itself is being paid is one of the unacceptable faces of the building and construction industry.

The time has come for that position to be regulated rather than continuously ignored.

When the subcontractor has done most of the work upon a building project and the owner has paid a progress payment which is largely referable to the subcontractor's work, there is really no moral defence for non-payment. The head contractor in those circumstances has simply taken what is in reality the subcontractor's entitlement.

No civilised well informed society with a well developed sense of what is right and what is wrong should stand for that and the time is right to address the issue. A point well echoed in Collier's article entitled "The Nuts and Bolts of Bankruptcy, Trust Funds, and the Construction Industry: Building a Solution for Subcontractors Nailed with an Unpaid Bill":

The construction industry is a unique sector of the United States economy that legislatures and courts throughout this country recognize as needing special rules for continued vitality. The most dramatic problems within the industry naturally involve money. Particularly troublesome is the fact that many construction projects require time and monetary commitments that, if compromised, can result in complete financial ruin of all the project parties. Logically, such a compromise is likely to occur when a subcontractor is not paid by a contractor who has received funds from an owner that will ultimately go to the unpaid subcontractor. State legislatures have counteracted this effect by enacting mechanic's lien laws. Some states have gone even further by enacting state trust fund statutes, such as the Michigan Builders Trust Fund Act. Even Congress has given some relief to construction parties in the Code by allowing the perfection of mechanics' liens post petition, despite the automatic stay.

Public policy and the nature of the construction industry play a large role in many courts' decisions. Several courts have noted the exceptional troubles unique to the construction industry that mandate the use of constructive trusts and other vehicles for subcontractor recovery. In Selby, the court stated,

[l]ike the law merchant of an earlier day, the building trades have gradually created a set of commercial expectations as the result of the customs and practices of the industry. The nature of the industry is such that the commercial expectations of the parties are defeated when a building contractor or subcontractor does not use accounts paid to him on a job to pay subcontractors or materialmen. Unless the parties see that construction funds are properly applied down the line, the liabilities of the parties up the line are affected. The unpaid workers must undertake the lengthy and wasteful process of filing, perfecting and foreclosing on their mechanics['] liens. The owner's property and the construction lender's security are encumbered.²⁵³

The statutory approach to the construction trust

The Inquiry has concluded that a statutory construction trust ordered along the lines of the construction trust legislation that exists in the American State of Maryland should be preferred.

After considering the various forms of construction trust provisions enacted in Canada and America, the Inquiry sets out below three legislative “construction trust” models as a stimulus for analysis and comparison – being, Maryland (America), British Columbia (Canada) and Ontario (Canada).

The Inquiry's own recommended legislative construction trust provisions draws upon this comparison.

Maryland

The Maryland construction trust legislation provides:

Real Property Code Ann

Title 9. Statutory Liens on Real Property:

Subtitle 2: Trust relationships in the Construction Industry

Moneys to be held in trust.

Any moneys paid under a contract by an owner to a contractor, or by the owner or contractor to a subcontractor for work done or materials furnished, or both, for or about a building by any subcontractor, shall be held in trust by the contractor or subcontractor, as trustee, for those subcontractors who did work

²⁵³ Collier, K.W., “The Nuts and Bolts of Bankruptcy, Trust Funds, and the Construction Industry: Building a Solution for Subcontractors Nailed with an Unpaid Bill (2004-2005) 21(2) *Emory Bankruptcy Developments Journal* 623 at 661.

or furnished materials, or both, for or about the building, for purposes of paying those subcontractors.²⁵⁴

(“the Maryland construction trust legislation”)

British Columbia

Section 10 of the *Builders Lien Act S.B.C 1997, c.45* provides for the construction trust in the following terms:

10. Contract money received constitutes trust fund.

10(1) Money received by a contractor or subcontractor on account of the price of the contract or subcontract constitutes a trust fund for the benefit of persons engaged in connection with the improvement by that contractor or subcontractor and the contractor or subcontractor is the trustee of the fund.

10(2) Until all of the beneficiaries of the fund referred to in subsection (1) are paid, a contractor or subcontractor must not appropriate any part of the fund to that person’s own use or to a use not authorized by the trust.

10(3) If the liens of a class of lien claimants are discharged under this Act by the payment of an amount that is less than the amount owing to the person who engaged the class, the members of the class are subrogated to the rights under the subsections (1) and (2) of the person who engaged the class.

10(4) Subsections (1) and (2) do not apply to money received by an architect, engineer or material supplier.

Ontario

Section 8 (1) of the *Ontario Construction Lien Act R.S.O. 1990, c.30* (the Ontario Act) provides:

“All amounts,

- a) owing to a contractor or subcontractor, whether or not due or payable; or
- b) received by a contractor or subcontractor,

on account of the contract or subcontract price of an improvement constitute a trust fund for the benefit of the subcontractors and other persons who have

²⁵⁴ Md. Code Ann. Real Prop. Section 9-201(2012) – Title 9: Statutory Liens on Real Property; Subtitle 2: Trust Relationships in the Construction Industry.

supplied services or materials to the improvement who are owed amounts by the contractor or subcontractor.

Other sections of the Ontario Act are worthy of replication in the statutory construction trust amendment to be recommended in NSW.

For example, section 8(2) of the Ontario Act under the heading Obligations as trustee, provides:

“Obligations as trustee

The contractor or subcontractor is the trustee of the trust fund created by subsection (1) and the contractor or subcontractor shall not appropriate or convert any part of the fund to the contractor’s or subcontractor’s own use or to any use inconsistent with the trust until all subcontractors and other persons who supply services or materials to the improvement are paid all amounts related to the improvement owed to them by the contractor or subcontractor.”²⁵⁵

By that means, a cascading or waterfall effect is created so that each contractor or subcontractor holds funds down the line on trust for the person with whom they were in contract. Section 8(2) of the Ontario Act makes it plain, as does section 8(1), that the cascading trust applies to suppliers as well as to contractors and subcontractors. That is as it should be. Generally one would expect there to be only two broad types of trusts, one at head contractor and the other at subcontractor level. Each is distinct from the other.

Speed of payment out of the construction trust account to the subcontractor is ensured by the 28 day payment requirement recommended by this Inquiry, coupled with SOPA.

What is recommended is not a holding trust or a block upon payment. A speedy nil balance in the trust account is a sure sign of success.

To ensure that the trust provisions are all embracing and disbursed, work to protect subcontractors and suppliers where trust funds are wrongfully applied, the Inquiry also recommends that a provision similar to section 13(1) of the Ontario Act should be enacted in NSW.

Section 13 (1) of the Ontario Act, provides that:

13(1) Liability for breach of trust by corporation

²⁵⁵This is the equivalent of the words in s.10(2) of the British Columbia Builders Lien Act S.B.C 1997, c.45.

In addition to the persons who are otherwise liable in an action for breach of trust under this Part,

1. every director or officer of a corporation; and
2. any person, including an employee or agent of the corporation, who has effective control of a corporation or its relevant activities,

who assents to, or acquiesces in, conduct that he or she knows or reasonably ought to know amounts to breach of trust by the corporation is liable for the breach of trust.

The Inquiry's recommendations

Whilst the legislative draftsmen from different jurisdictions have employed different approaches to the precise terms considered appropriate to incept the statutory construction trust, the Inquiry is of the view that the Maryland construction trust legislation is to be preferred, subject to the relevant provisions being:

- i. accompanied by a suitably expansive definition of “building”;
- ii. expanded to capture moneys received “on account” for work to be done and/or materials supplied (s.10(1) of the British Columbia Act & s.8(1) of the Ontario Act); and
- iii. incorporating provisions which provide for liability for breach of trust by corporation (cf: s.13(1) of the Ontario Act).

The amendments which the Inquiry has recommended should take the form of an additional chapter in SOPA.

Views on the Inquiry's trust proposal

As stated earlier in the Report, the Inquiry has encouraged all interested parties from the industry and community to provide their views, comments and suggestions. In developing and workshopping its recommendations, the Inquiry approached Mr John Melliush, Partner in the firm Ferrier Hodgson, to analyse a preliminary non-binding draft of the Inquiry's recommendations. Mr Melliush was specifically invited to research and express an opinion upon the introduction of a project based trust account along the lines of the Inquiry's proposed model of the statutory construction trust account.

The following points which Mr Melliush raised and which the Inquiry found represent the concerns and questions raised by others include:

- *“There will however be a threshold issue in that some small scale projects may not warrant the administrative burden of creating such an account. In my view a dollar limit could be set, or alternatively addressed within the licensing requirements.*
- *Surplus funds could be placed on interest bearing deposit noting the same legal owner as deposit holder.*
- *Consideration needs to be given to whether the Trust Account requires auditing from time to time, as is the case with many other industry held trust accounts. I note that the auditing requirement will generally be driven by the governing body, rather than any current statute. Of course the requirement to audit would carry an increased cost of doing business.*
- *Consideration will need to be given to the amount the Head Contractor is entitled to draw from particular progress payments in order to cover overheads and other costs. Potentially the drawdown request could contain this information, as well as details of other intended beneficiaries of the drawdown payment. In order to encourage the timely distribution of funds to sub-contractors provision could be made to make payment to other beneficiaries prior to any related party payments being made.*
- *Upon the potential insolvency of the Head Contractor, there will likely be times at which the retained trust funds are insufficient to make payment to all sub-contractors in which case there will need to be a defined process to deal with that eventuality. Consideration also needs to be given to the costs associated with administering the Trust Account post-insolvency as a Liquidator or other external administrator will be unwilling to get involved in the distribution of the fund unless he or she will be paid for doing so. It would be an impost on other creditors if those costs were merely added to the costs of the Liquidation.”²⁵⁶*

In developing the statutory construction trust regime now recommended by the Inquiry, the Inquiry took inspiration from the wise words of experienced Ontario lawyer and legal commentator, Duncan Glaholt, who shared these comments with the Inquiry about the process for introducing statutory construction trust legislation in Canada:

“In our reform here in Ontario back in 1983 some basic goals were identified. They may help resolve each of the questions you have asked:

- Encourage cash flow: Construction industry cash flow is large and fragile. If we are all “six missed meals from anarchy”, as someone once said, then the construction industry is two missed progress payments from insolvency.*

²⁵⁶ John Melluish, Ferrier Hodgson 6 November 2012

- b. *Respect party autonomy: Interfere as little as possible in parties' power to contract in protecting those without bargaining power.*
- c. *Conserve resources: Economy of remedy is essential. We need to pay close attention to the benefit/burden of any remedy.*²⁵⁷

The Inquiry's proposed construction trust has the following essential features:

- The payments from the head contractor to the subcontractor and suppliers cascading downward should be paid into and retained in a separate bank account.
- The principal is to be required to pay the moneys agreed to be due and payable to the head contractor within 15 days of the receipt of a progress payment in the proper form.
- The head contractor is to pay to the subcontractor or subcontractors as the case may be, the amounts not in dispute and properly set out in the progress payment.
- If there is a dispute as to what is due and payable either to the head contractor by the principal or by the head contractor to one or more of the subcontractors, then such dispute is to be dealt with in accordance with the provisions of SOPA.
- Once the principal, the head contractor or the subcontractor have paid moneys into the relevant respective construction trust account, then each beneficiary claiming to be entitled to the payment of moneys out of that account is entitled to call upon the trustee to provide up-to-date details of trust account details in the form of copies of the current account balances.
- After payment by the principal into the original trust account, the contractor shall be entitled to deposit the progress payment into an account with any one or more of the authorised investments set out in the NSW *Trustee Act 1925* and if the trustee elects to do so it must ensure that the account to which the funds are transferred continues to be described as a trust account for payment to subcontractors and suppliers in respect of the particular project name.
- Upon payment of all moneys found or agreed to be due and payable to the subcontractors, sub-subcontractors and suppliers, the contractor shall be entitled to retain the income earned upon the investment of the trust fund described above, for the period from the receipt of those funds from the principal, head contractor or subcontractor as the case may be, to the time and date of payment

²⁵⁷ Duncan Glaholt, Partner Glaholt LLP, Ontario Canada, letter dated 15 November 2012.

to the head contractor, subcontractors, sub-subcontractors or suppliers as the case may be.

The suggested statutory construction trust recommended by the Inquiry, recognises that the moneys are held on trust but upon a special kind of trust, one which is designed to ensure that when the time arrives for payment in accordance with the recommended prompt payment provision of this Report, that the moneys remain protected. The statutory provisions above ensure that once the moneys have been impressed with a trust upon the payment into the first account, that any payment out of that account remains impressed with the trust and is traceable into the new account properly named and clearly described as a construction trust account.

The above recommendations also recognise that the beneficiary whether it be the subcontractor or a sub subcontractor or supplier, has no right to call for the money before the expiration of the statutory period for payment. What the beneficiary has, is merely a right to insist that the money not be paid away for purposes which are foreign to the construction trust. Under the old law, if the recommendation is accepted, the contractor could have invested the amount of the progress payment from the principal or head contractor as the case may be and would have been entitled to retain any investment income earned even if the contractor was in breach of the agreed payment terms with the subcontractor.

A legal analysis of the mechanics of the construction trust

Elements of a trust

“A TRUST CREATED BY STATUTE

A trust has been defined as,

“The relationship which arises whenever a person called the trustee is compelled in equity to hold property, whether real or personal, and whether by legal or equitable title, for the benefit of some persons (of whom he may be one, and who are termed beneficiaries) or for some object permitted by law, in such a way that the real benefit of the property accrues, not to the trustees, but to the beneficiaries or other projects of the trust”.

In order for a trust to arise three characteristics must be present, namely: 1) certainty of intent to create a trust, 2) certainty of the subject matter of the trust and, 3) certainty of the objects or beneficiaries. A statutory trust is simply a trust relationship created by statute. Mr. Justice Meredith in B.C. (Govt.) v.

Henfrey Samson Belair Ltd defined a statutory trust as follows, “A statute creates a trust when the language vests ownership to an asset in someone other than the holder A trust created by statute will be effective to vest title so that the asset deemed to comprise the trust property does not form part of the property of the holder. And if the holder is bankrupt, the asset does not form part of his estate....

...Although a trust may be created by statute, it must still meet the basic requirements of a trust, namely the requirements of certainty. In the area of the builders’ lien trusts, certainty of intent is not a problem as it is clear from the legislation itself.”²⁵⁸

The construction trust is of course a creation of the statute in which it is embodied, yet the trust follows classical trust lines and so it would be prone to failure if each of the necessary elements to constitute a valid trust were not found to be present.

Those elements are:

- A settlor²⁵⁹
- A trustee
- An intention to create a trust²⁶⁰
- A specific fund to constitute the trust property²⁶¹
- A beneficiary²⁶²

²⁵⁸ Ettinger, L. P., “Trusts in the Construction Industry” (1988-1989) 27(3) *Alberta Law Review* 390 at 400.

²⁵⁹ See *Registrar, Accident Compensation Tribunal v Commissioner of Taxation* (1993) 178 CLR 145 at 175 per Brennan, Dawson and McHugh JJ, as found in Meagher, R.P. and Gummow, W.M.C., *Jacobs’ Law of Trusts in Australia*, 6th ed., 1997, Butterworths, Sydney.

²⁶⁰ The three certainties of a trust must be established (subject, intention and object): *Knight v Knight* [1840] EngR 862; (1840) 3 Beav 148 (cited in Davis R., *Construction Insolvency*, p. 259). Intention to create a trust is inferred from the circumstances and may be established without the word “trust” itself (*Re Kayford* [1975] 1 WLR 279). Onus of proving intention lies on the person alleging that a trust was created (*Re Armstrong* [1960] VR 202 at 206 per Herring CJ in Dal Pont, G.E., *Equity and Trusts in Australia*, 5th ed., 2011, Lawbook Co., Sydney, p. 511). For cases relating to construction insolvency, see also *Glen Eight v Home Building* [2005] NSWSC 309; *Tecof International v Town Castle* (2009) 1 P & CR DG23; *Anaconda Operations v Fluor Daniel* [1999] VSCA 214.

²⁶¹ There should be property capable of being held on trust (*The Public Curator of Queensland v The Union Trustee Co of Australia Ltd* (1922) 31 CLR 66 at 74-5, per Higgins J, cited in Meagher, R.P. and Gummow, W.M.C., *Jacobs’ Law of Trusts in Australia*, 6th ed., 1997, Butterworths, Sydney, p. 5). There must be certainty in identification of the property bound by the trust (*Herdegen v Federal Commissioner of Taxation* (1988) 84 ALR 271 at 277-280). See also *Moriarty v Various Customers of B A Peters* [2010] 1 BCLC 142 and *Re Global Trader* [2009] 2 BCLC 18.

²⁶² The “beneficiary principle” is that a trust must be in favour of definite beneficiaries, ascertained or capable of ascertainment, or in favour of a recognised charitable purpose (*Morice v Bishop of Durham* (1804) 9 Ves 399 at 404-405; 32 ER 656 at 658, as cited in *Dal Pont* 5th ed., p. 522). A trust can be created without communication to the beneficiary (*Middleton v Pollock* (1876) 2 Ch D 104, at 106 per Jessel MR;

- The terms of the trust²⁶³

Each of the requisite elements is present in the form of the statutory construction trust recommended by the Inquiry. In none of the analyses of the trust carried out thus far, has it been suggested that the trust would fail for want of one or more of the essential elements.

The settlor

The settlor is the principal. However, once a trust is created then the nature and identity of the settlor is usually not relevant for any material purpose as the settlor has become a stranger to the trust and has no right to interfere with the trust relationship between the trustee and beneficiary.²⁶⁴

An intention to create a trust

The intention to create the trust is evidenced by the payment to the head contractor by the principal which can be explained by the contractual obligation to do so and the relevant statutory provision. The payment is, in a sense, a self-executing intention which boilerplates upon the statute which creates the construction trust.

When does the trust come into existence?

There are a number of circumstances in equity in which the precise point at which a trust arises has been a matter of debate. For example in the law of vendor and purchaser one of the practical consequences of an answer to that question is whether there has been a “disposal” of land that renders the vendor liable to capital gains tax. This is particularly important in the United Kingdom.²⁶⁵

Rose v Rose (1986) 7 NSWLR 679 at 686 per Hodgson J, as cited in *Jacobs’ 6th ed.*, p. 5), but the beneficiary may disclaim (*Re Gulbenkian’s Settlements (No 2)* [1970] Ch 408 at 418 in *Jacobs’ 6th ed.*, p. 5). Semantic uncertainty may cause the object to be too uncertain (*Re Gulbenkian’s Settlements* [1970] AC 508 at 524 per Lord Upjohn, in *Dal Pont 5th ed.*, pp. 524-525). But there is no difficulty where words used are capable of being interpreted with certainty by the court (*Re Golay’s Will Trusts* [1965] 1 WLR 969 at 972 in *Dal Pont 5th ed.*, p. 519). Not all persons to benefit may be ascertained when the trust commences but there must be such a description as will enable them to be ascertained whenever necessary (e.g. *Kinsella v Caldwell* (1975) 132 CLR 458 at 461, per McTiernan, Stephen and Mason JJ). See also *OT Computers v First National Trinity Finance* [2003] EWHC 1010; *ESPL v Radio & General Engineering* [2005] 2 MLJ 422 and *Henry Boot v the Croyden Hotel* (1985) 36 BLR 41.

²⁶³ Trusts are “equitable obligations to deal with property in a particular way” (*Re Williams* [1897] 2 Ch 12 at 18. Cited by Isaacs J in *Glenn v Federal Commissioner of Land Tax* (1915) 20 CLR 490 at 503, as found in *Jacobs’s 6th ed.*, p.3).

²⁶⁴ See *Re Smith* (1971) DLR (3d) 130 and Chambers, R., “Restrictions on the Use of Money” in Swadling, W. (ed), *The Quistclose Trust: Critical Essays*, 2004, Hart Publishing, Oregon and the Quistclose Trust Critical Essays, p. 80

²⁶⁵ See *Jerome v Kelly* [2004] 1WLR 1409; Aitken, L. p. 497 “‘Segregation’ of funds, insolvency, and the ‘statutory trust’” (2012) 128 *Law Quarterly Review* 497; and the article by PG Turner in the same volume

In the range of factual possibilities under examination for present purposes, the drafters of any provisions creating a statutory construction trust will be required to direct attention to the point at which the trust comes into being. As Mr Lee Aitken's article in the *Law Quarterly Review* entitled "'Segregation' of funds, insolvency, and the 'statutory trust'"²⁶⁶ illustrates, that question can acquire great importance in an insolvency.

The two possibilities are that the trust can arise immediately upon receipt of the money by the head contractor and the second possibility is that there can be a *scintilla temporis* or a spark of time during which the money is in fact the property of the head contractor.

In the helpful article written by Mr Aitken which deals with the recent decision in *Re Lehman Brothers International (Europe) (in administration)*²⁶⁷ the question was whether or not there was in Lord Hope's Scottish legal language an:

“... interval between the moment of receipt and the commencement of the *fiduciary* relationship during which the agent can treat the money as his own”²⁶⁸.

If there was a moment between receipt of the funds during which the contractor owned the funds, then that circumstance could give rise to the conclusion that there had been a payment by the head contractor in its own right which may be attached as a preference.

In this way, the statutory trust brings about a reclassification of the relationship between the principal and the head contractor which previously rested entirely in contract. It confers additional and different rights upon the subcontractor.

The subcontractor becomes a beneficiary with rights *in rem* against the trust fund which places it in a position to claim against a fund which is not available to the creditors of the insolvent company.

Secondly, it is perhaps more accurate to say that by impressing those moneys within the construction trust they are no longer (indeed they never were) moneys beneficially owned by the company. In that way the trust money is not available to be distributed to

(October 2012) at page 582. See also *Karak Rubber Co Ltd v Burden (No 2)* [1972] 1 All ER 1210; *Selangor United Rubber Estates Ltd v Craddock (No 3)* [1968] 2 All ER 1073; *Consul Developments Pty Ltd v DPC Estates Pty Ltd* (1975) 132 CLR 373 and *Farah Constructions Pty Ltd v Say-Dee Pty Ltd* [2007] HCA 22.

²⁶⁶ (2012) 128 *Law Quarterly Review* 497.

²⁶⁷ [2012] UKSC 6; [2012] 1 All ER.1.

²⁶⁸ *Re Lehman Brothers International (Europe) (in administration)* [2012] UKSC 6; [2012] 1 All ER.1, per Lord Hope at [2]; See Aitken, p. 498.

the company creditors in an insolvency. The company holds the bare legal title to the fund and holds the beneficial interest on trust for the subcontractors. There is no *scintilla temporis* within which time there may be a spark that results in the legal and equitable interest both being owned by the contractor, leaving the fund prey to interception by other interests. The moment the money is paid to the head contractor by the principal, the trust is established. There is no point at time at which a creditor may assert a claim against a fund in which the contractor has both the legal and the full equitable interest.

The trust property

It is necessary also to say something concerning the *ascertainment* of the relevant trust property. What obliges the trustee/contractor to pay out the money to the subcontractor is a combination of:

- (i) the contractual obligation to pay which is to be found in the contract;
- (ii) the trustee's obligation to act in accordance with the trust – that is, to pay the subcontractor; and
- (iii) the statutory obligation to pay promptly.

The latter two are to be found in the Inquiry's recommended statutory provisions.

When all these obligations are considered, together with the Inquiry's recommendation that an obligation should also be imposed upon the principal to pay the head contractor promptly, it can confidently be expected that those provisions in combination will bring about a radical reform in the industry.

Disputes

That analysis does not however, answer the questions raised by the existence of a *dispute* as to the precise amount of money owed by the head contractor to the subcontractor or, for that matter, by the principal to the head contractor.

A recommended model which does not answer that question and at the same time ensures that any recommendations neatly dovetails with the provisions of SOPA, which so often controls the field of principal/head contractor/subcontractor payments during the course of the relevant project, would in turn fail to recognise the likelihood of the trust failing for want of specificity of trust property. It would also fail to recognise and prevent the confusion which would arise if SOPA was not allowed to do its existing job while at the same time readily accommodate the new tasks required of it by the implementation of the recommendations made by the Inquiry.

The Report is shortly to commence an analysis of the waterfall effect,²⁶⁹ the gravity driven vertical pattern of contractual relationships in which the head contractor stands underneath the principal and then the subcontractor or subcontractors stands under the head contractor and then down through to suppliers.²⁷⁰ For that reason the answer to the question what happens if there is a dispute between any two or more contracting parties in the vertical chain, as to the amount due and owing can and is best answered by reference to that model.

Similarly the Report can in so doing, answer questions concerning the creation of succeeding trusts down the vertical chain involving those who are in a contractual relationship with each other. That is not to blur the essential distinction between a contractual relationship and a trust relationship. Rather, it is to say that the trust so created is established as between two companies or entities which are in a contractual relationship with each other, where one of those contractual parties has received moneys which is intended to be paid to the other in fulfilment of a contractual promise to do so as payment for work done.

If the head contractor holds all or any money on trust it does so because the relationship falls within the meaning and intent of the words used in the particular statute which creates the statutory trust. For example, see the Maryland construction trust legislation. It is necessary, logical and sensible that the money should be paid out of the statutory trust by a person who is under an obligation to do so. That obligation exists by reason of the statutory provisions creating the construction trust. At the same time that the head contractor (as trustee) discharges its obligation by paying the money to the relevant subcontractor (as nominated beneficiary), it is also acquitted of its contractual obligations.

The statutory construction trust works hand in glove with SOPA

It is necessary for the sake of good order and contract administration that SOPA remain the source of the statutorily prescribed mechanism concerning progress payment disputes. **A rapid adjudication mechanism is an essential element in the Inquiry's proposed model.**

By this means a more rapid and efficient identification of the moneys that are not in dispute and the moneys that may be in dispute, can be achieved. Moreover, the proper identification of these moneys enables the machinery of SOPA to work efficiently in association with the trust.

²⁶⁹Sometimes called the "cascading effect" of the vertical contractual relationships.

²⁷⁰In the Inquiry's recommendation, the expression subcontractor includes "suppliers".

For those reasons it is not necessary to enact an ancillary provision which obliges each of the participants in the vertical chain to set out their progress claim in a manner which differs from SOPA.

A reference to the words of the Maryland construction trust legislation existing statutory provisions in other jurisdictions will also answer the question: What is the necessary form of words required to establish each trust and what is the trust property? As previously stated, the trust property will consist of moneys that are found to be due and payable to the subcontractor, sub-subcontractor and supplier, as the case may be, and the trust will be set up for the purposes of ensuring that those payments are made.

The interaction of the statutory construction trust with common insolvency law

The question of preferences

The statutory construction trust when properly established is one that invokes a mechanism upon which it depends for its creation, which does not allow the payment from the principal to the head contractor to rest at any time in an account owned and controlled by the contractor.

The money paid by the principal²⁷¹ is deposited immediately into the trust account and does not rest for a moment in an account which is “owned” by the head contractor. If it was otherwise and if the payment was made directly to the head contractor who then itself paid money into the construction trust account, that payment would be subject to the Commonwealth insolvency laws particularly those which apply to the giving of a preference.

As the nature of the Inquiry’s work has essentially involved consideration of the consequences of insolvency, naturally it is required to examine the question of preferences.

An unfair preference is defined in section 588FA(1) of the *Corporations Act 2001* (Cth) as follows:

588FA Unfair preferences

- (1) A transaction is an unfair preference given by a company to a creditor of the company if, and only if:

²⁷¹ And the same applies to money paid further down the chain by the head contractor and the subcontractors and so on.

- (a) the company and the creditor are parties to the transaction (even if someone else is also a party); and
- (b) the transaction results in the creditor receiving from the company, in respect of an unsecured debt that the company owes to the creditor, more than the creditor would receive from the company in respect of the debt if the transaction were set aside and the creditor were to prove for the debt in a winding up of the company;
even if the transaction is entered into, is given effect to, or is required to be given effect to, because of an order of an Australian court or a direction by an agency.

In determining whether a transaction is voidable as an “unfair preference”, consideration must be given, in addition to section 588FA, to other relevant sections of the Act dealing with “Voidable Transactions”²⁷² – specifically, sections 588FC (Insolvent Transactions), 588FE (Voidable Transactions), 588FF (Courts may make orders about voidable transactions) and 588FG (transaction not voidable against certain persons).

When examining the recommended trust structure in this Report it is vital that any of the payments involved in the operation of that machinery be scrutinised to ensure that they do not fall foul of the voidable transaction provisions in Part 5.7, Division 2 of the *Corporations Act* and be recoverable by a liquidator as an “unfair preference”.

Generally speaking, to recover an unfair preference payment a liquidator must establish that:

- a. The company and the creditor were parties to the transaction (s.588F(1)(a));
- b. The transaction resulted in the creditor receiving from the company, in relation to an unsecured debt owed to the creditor, more than it would receive if the transaction were set aside and the creditor were to prove the debt in a winding up of the company (s.588F(1)(b));
- c. The transaction was entered into at a time the company was insolvent (s.588FC); and
- d. The transaction was entered into within the 6 months ending on the relation-back day or after that day but on or before the day when the winding up began (s.588FE).

Similar questions have arisen in Canada and the United States where there has been the customary contest between different claimants to a fund which is insufficient to pay out all such claimants. Disputes of that nature involve at their heart the question whether

²⁷² *Corporations Act 2001* (Cth), Part 5.7, Division 2 (ss.588Fa to 588FJ) “Voidable Transactions”.

certain moneys are or are not moneys of the company and therefore are available for distribution to the general creditors *pari passu*, in the insolvency.

Such disputes are as old as the law of insolvency itself. The means by which the construction trust is established ensures that difficulties of that nature are sidestepped.

The Inquiry's proposed statutory construction trust model

The head contractor's trust

In the modern world of construction roughly 80% of the amount of money claimed in a head contractor's progress payment will be claimed as a result of work carried out at by one or more subcontractors and suppliers.

Let it be assumed that money is owed by the principal to the head contractor.

When the head contractor is paid that progress claim by the principal, the head contractor will hold that amount on trust. That is the only trust with which the head contractor will be concerned, namely the trust between the head contractor and the subcontractor or subcontractors with whom it is in a contractual relationship. All that the head contractor owes to that one particular subcontractor or subcontractors will be contained in that trust fund and that is the only trust fund which that head contractor is required to be involved.²⁷³

When the head contractor pays that amount of money due and owing to the subcontractor (upon the assumption for the moment that there is no dispute upon what is due and payable), that trust has been executed. There is nothing more for the head contractor to do although a trust almost identical to that trust will arise upon the payment of the next progress claim by the principal to the head contractor provided of course that there is subcontractors' moneys within the payment.

In each case, the method by which the trust comes into existence, is facilitated, is evidenced and is then discharged, by the simple application by deposits into and out of a bank account.²⁷⁴ As each of these deposits into and out of a bank account have to be made in any event, it is impossible to see what extra administrative effort or cost is involved in that exercise.

²⁷³ It is important to analyse as the Inquiry does later in this Trust section, what the position is if there are more claims upon the trust fund than there are money in the trust fund itself.

²⁷⁴ However, the Inquiry notes that there is in fact no reason in principle why the amount could not be paid into an account maintained with some other kind of non-bank financial intermediary.

To that observation must be added an important qualification. That is, that if in accordance with the recommendations made by the Inquiry, a specific segregated trust account is created so that the money cannot be comingled with other moneys in other bank accounts then the head contractor will be obliged to expend whatever moneys are necessary to open that additional account. It is hard to imagine that in the light of a continuing significant banking relationship already in existence between the head contractor and the banker that there would be much more involved than the payment of a small fee and the completion of a number of forms.²⁷⁵

The subcontractor's trust

As the money then moves down through the chain from head contractor to subcontractor, another trust will be established as between the subcontractor and sub-subcontractors and/or suppliers, as the case may be, in which the subcontractor is the trustee of those moneys paid out of the first trust account established by the head contractor and said to be due and payable to the sub-subcontractors.

Any repetition involved in that stage in the cascading trust is not a repetition of work that had to be carried out by the head contractor. The Inquiry wishes to make clear that no obligations or duties arise for the head contractor/trustee of the first trust, in respect of this next trust. It is a new obligation imposed upon the subcontractor and the steps and the actions involved in that trust are, *mutatis mutandis*, the same as those involved in the earlier trust.

And so it continues down the vertical line....

Each trustee pays the amount of money to the beneficiary with whom it has a pre-existing contract obliging it to make payment to that beneficiary.

If, in turn, subcontractors or sub-subcontractors or for that matter the head contractor has a contract with a supplier and that contract meets the descriptive terms of the statutory construction trust, then again, *mutatis mutandis*, the same principles apply.

The test recommended at each level in this analysis is whether there is within the meaning of the terms of the section, a set of circumstances in which a payment is made to the head contractor and the owner and subcontractor has executed work and supplied materials then the head contractor holds that sum on trust until the subcontractors are paid.

²⁷⁵ See for example the ANZ Bank document entitled "Statutory Trust Account Terms and Conditions – ANZ Business Banking | 04.12" which contains terms and conditions for Statutory Trust Accounts and other banking ANZ products.

Resolving disputes

If there is a dispute as to what is due and payable either in or out of the construction trust fund then SOPA lies alongside the Inquiry's recommended trust provision as a means to provide rapid interim relief for a head contractor, or equally a subcontractor who alleges it has been not been paid or that it has been underpaid. The adjudication procedure set up under SOPA ensures that the money gets out to its proper destination, in an interim sense, and if there is to be any argument about the adjudication itself, then the aphorism "pay now argue later" comes into effect. Then there will be either a proceeding in a court of competent jurisdiction or an arbitration as the case may be. In the meantime, once there has been an adjudication, that adjudication will govern the amount to be paid into or out of the construction trust account. Similarly, if there is no dispute as to the amount due and payable to the subcontractor then that amount should be paid out of the construction trust fund in accordance with the recommended prompt payment legislation to which reference has been made above.

If there is a dispute at the top level of the chain - that is between the principal and the head contractor as to the amount owing to the head contractor - then the provisions of section 13 of SOPA and the process under that Act will be enlivened for the purposes of determining the interim amount owing. Any amount so determined by the process of adjudication to be payable by the principal to the head contractor is paid into the trust account maintained by the head contractor.

Of course the amount in dispute must be paid out in accordance with the recommended prompt payment provision referred to elsewhere in the Inquiry's Report.²⁷⁶ It will be necessary to ensure that SOPA is brought into alignment with the statutory trust and the statutory obligation to pay within 15 and 28 days for principals and head contractors respectively.

Turning now to the second level of the vertical analysis - that is between the head contractor and subcontractor as to an amount owing to a subcontractor - it is still necessary to work out how the overall model that is the amalgam of SOPA and the recommendation of the Inquiry, if implemented, would work in other circumstances.

In the event there is a dispute as to the amount due and payable to a particular subcontractor then the subcontractor:

- shall be paid by the head contractor out of the construction trust moneys such amount that is not in dispute; and
- shall as is its entitlement in any event, be at liberty to make an application for adjudication pursuant to the provisions of SOPA.

²⁷⁶Which needs to be drafted so as to be subject to the provisions of SOPA.

Problem Scenario:

Take, for example, a claim by a subcontractor for \$100,000 for which \$50,000 was not contested, but there was a genuine contest as to whether the balance of \$50,000 was owing. Assume also that the subcontractor, through the adjudication procedures provided for under SOPA, has had the dispute determined but has been completely unsuccessful in respect of its claim for the disputed \$50,000. For argument's sake, there must be a genuine theoretical possibility that when the project is over and the time has long past for the "pay now" section of SOPA, that the subcontractor can still have his day in arbitration or in court and "argue later" that he is still entitled to the \$50,000.

Question:

In those circumstances:

- (i) Does the \$50,000 fall outside the statutory construction trust if the subcontractor later sues at law, and succeeds?
- (ii) What is to happen in the meantime if there is an intervening insolvency of the head contractor?

The Answer

- (iii) **Yes if the terms of the Maryland section are satisfied and a subcontractor has supplied work and materials in the performance of a contract with the subcontractor.**
- (iv) **The subcontractor only has a claim as an unsecured creditor in the head contractor's insolvency.**

The nature and character of the bank account: the requirement for a separate trust account

In order to answer the question whether there should be a separate bank account it is necessary and appropriate to examine briefly the history of financial misappropriation and the so called rule in *Barnes v Addy*²⁷⁷ as it came to be applied particularly in the 1960s' in cases in the United Kingdom where the victims of the fraudulent act of an impecunious fraudster led to a dispute between the defrauded company and either banks or accountants or solicitors who have played some part in the payment away of such moneys. The cases which are of importance to the recommendations to be made by the Inquiry in this section of the Report, are those which involve the participation with knowledge of a third person in a breach of a particular trust and will apply in principle to breaches of the statutory construction trust.

²⁷⁷ (1893-94) LR 9 ch App 244

There are a number of reasons why in the Inquiry's view it is important that the trust account be maintained separately and be segregated as a trust account and so named. For example, under the general law and before any question of insolvency arrives, a bank has the right to combine its customers account into a single balance and apply available funds in payment of only indebtedness. That right is not available to a bank where an account has been separated out by agreement and specifically described as a trust account.²⁷⁸

For example, it has long been regarded as a contrary indication of a trust that the lender has not required the borrower to keep particular funds separate from its own assets.²⁷⁹

In *Re Kayford*²⁸⁰ for example, money had been paid by mail order customers in advance at the time they were ordering goods. The money thus paid was deposited into a trust account for their benefit to be released to the company supplying the goods only on delivery of the goods. The supplier company became insolvent. The provisions of the sales documentation setting up the trust account were held not to be a preference.

The decision of Bingham J. (later Lord Bingham) in *Nestlé Oy v Lloyds Bank*²⁸¹ is of interest. In that case a shipping company had agreed to pay its agent in advance for expenses incurred by the agent. When the agent became insolvent the company sought a declaration that the funds paid for those expenses which had not yet been incurred were held on trust. Five of the six payments so made were held by the judge not to be held on trust although the sixth payment was found to be held upon a constructive trust in favour of the company on the grounds it was received after the agent had decided to stop trading.²⁸²

The Western Australia Law Reform Commission (WALRC) also gave detailed consideration to the question whether a separate trust account should be required.

As the WALRC pointed out in its 1995 Discussion Paper, one limitation on the effectiveness of a trust scheme is that unless there is a requirement for a separate trust account and the trustee complies with it, the trust funds could become mixed with other

²⁷⁸ See Derham, R., *The Law of Set-Off*, 3rd ed., 2003, Oxford University Press, UK, p. 645; and Stevens, R., "Insolvency" in Swadling, W. (ed), *The Quistclose Trust: Critical Essays*, 2004, Hart Publishing, Oregon, p. 156.

²⁷⁹ See for example *Re EVTR* [1987] BCLC 646 and *Twinsectra Ltd v Yardley* [2002] AC 164 and Swadling, W. (ed), *The Quistclose Trust: Critical Essays*, 2004, Hart Publishing, Oregon, p. 17, para 2.

²⁸⁰ [1975] 1 WLR 279.

²⁸¹ [1983] 2 Lloyd's Rep. 658.

²⁸² "Trust money being paid over to a beneficiary is not preferential." See Stevens, R., "Insolvency" in Swadling, W. (ed), *The Quistclose Trust: Critical Essays*, 2004, Hart Publishing, Oregon, pp. 157-163 et seq.

money and therefore be unidentifiable.²⁸³ In doing so, it quoted the following extracts from Ettinger in support of the requirement for a separate trust account:

[it will] “...effectively eliminate a problem in (Canadian provinces) where a contractor pays trust money into his general account and his bank takes the money to cover the contractor’s previous indebtedness to the bank. As long as the bank did not have notice, actual or constructive, that the funds were subject to a trust, the bank is entitled to the money.”²⁸⁴

“The requirement of a separate trust account may seem onerous to those contractors and subcontractors who rely on the ability to borrow funds using accounts receivable as collateral. This is less of a problem than it appears for two reasons: (1) If the bank is lending money on the basis of accounts receivable, it is already taking into account the customers’ accounts payable and basically the trust obligations are the accounts payable, and (2) if the money is lent for the purpose of paying trust beneficiaries, the customer is able to repay the bank from trust funds without committing a breach of trust”.²⁸⁵

The WALRC also stated that:

“Many cases in Canada deal with the question of whether or not the bank was aware of the nature of the funds. A statutory trust itself does not constitute notice of a trust: *Macklem and Bristow* 9-28. If a bank is aware that the funds are trust funds, the bank is a participant in a breach of trust which makes it liable to the beneficiaries. In any case, the trustee is in breach of the trust for failing to preserve trust assets. If the trustee is a corporation, its officers and directors who are its operating mind will be personally liable: *ibid* 9-50 to 9-51.”²⁸⁶

For the following reasons the Inquiry has concluded that beginning with the progress payment made with the principal to the head contractor, progress payments should be made into a separate bank account:

- It will prevent the sorts of problems arising out of co-mingling which arise when funds are mixed.
- It will facilitate the tracing remedy.
- It will allow a ready identification of funds which are already impressed with the trust if, in accordance with the recommendations of this Report, the head

²⁸³ 1995 WALRC Discussion Paper, paras 3.20 to 3.22.

²⁸⁴ Ettinger, L. P., “Trusts in the Construction Industry” (1988-1989) 27(3) *Alberta Law Review* 390 at 398.

²⁸⁵ *Ibid*, p. 428

²⁸⁶ 1995 WALRC Discussion Paper, p.26, footnote 48.

contractor wishes to move the funds from the original trust account and place them in authorised investments of the kind specified under the NSW *Trustee Act 1925*.

- The clear badging of a trust account discourages a misapplication of the trust fund.
- The clear badging of the trust account educates the head contractor and emphasises that these funds are not as has been said to the Inquiry “its money to do with as it pleases”.
- It discourages and warns those who may be tempted to misapply the funds.
- It warns those who are in a position to knowingly participate or facilitate and places them on notice so that the principle in the *Barnes v Addy* as developed through the cases, will give to the subcontractor another remedy against the knowing participant in the breach of trust, in addition to those it would have had against any impecunious trustee who had misapplied the funds.
- The didactic purpose of the construction trust is also better served in the opinion of the Inquiry if as in the Canadian provinces such as Ontario, Alberta and British Columbia among others and the American States such as Arizona, Colorado, Delaware, Illinois, Michigan, New Jersey, Washington and Wisconsin among others, there is a specific subsection under the overall headline section that makes those who participate in such a breach of trust liable for doing so. See for example s. 13(1) of the Ontario Act.

For reasons outlined above and elsewhere in the Report, the requirement to operate a separate trust account is not an onerous administrative requirement that is likely to cause any problem in a sophisticated building contractor’s head office. A clearly designated trust account is a benefit to banks. It is a clear indicator of the only legitimate purposes for which payments may be made out of the trust account.

The requirement to maintain a separate bank account has been emphasised in a slightly different context in England where a standard form contract which provided that the contractor was to be treated as a fiduciary in relation to retention moneys, the contractor was held to be under a duty to set the retention money aside in a separate account.²⁸⁷

In *Rayack Construction Ltd v. Lampeter Meat Co. Ltd*²⁸⁸ it was held that a mandatory order could be made by a court requiring the contractor to set aside as a separate trust fund an amount equal to that part of the sum certified in any interim certificate by an architect as being retention money.

²⁸⁷ See *Wates Construction (London) Limited the Frantham Property Limited* (unreported) referred to in F Fitzpatrick “Retention Funds in Building Contracts” [1991] NLJ 1007 at 1007.

²⁸⁸ (1979) 12 BLR 34 at 38.

These cases are of parallel relevance in the Inquiry's examination of retention funds but for present purposes they demonstrate the perceived wisdom of ensuring that the trust moneys in the Inquiry's recommended construction trust are set aside in a separate account. In the Inquiry's view such a proposition is incontestable. The Inquiry has taken into account all of the problems that might arise if there is no separate trust account. Accordingly the Inquiry takes the view that the opening, operation and maintenance of a separate trust account should be made obligatory.

Opportunity for investment of trust moneys

Under the Canadian provincial statutes and in the United States where a number of states have similar statutes, the contractor may elect, and does so in any event, into which account at which particular financial institution the owner's progress payment is to be paid. The Inquiry recommends that it should be made clear by statute in NSW that:

- The funds paid to the contractor by the owner by way of progress payment must be paid into a separate segregated and properly named trust account which plainly describes the nature of the trust account and that the account and the proceeds thereof are being held by the contractor upon trust for specific subcontractors in a named project.
- The contractor trustee may later deposit the proceeds of the owner's progress payment into or with an authorised bank or non-bank financial institution prescribed under the *Trustee Act 1925* (NSW) and listed in clause 4 of the *Trustee Regulation 2010* (NSW).

In the event that the trustee/head contractor decides to transfer the amount of the progress payment or some part of it into another account then such funds remain impressed with the original construction trust and must be:

- deposited into a segregated separate trust account named in exactly the same way as the previous trust account;²⁸⁹ and
- available at call when the next subcontract progress payment is due for payment by the contractor.

Interest earned on progress payments

After all of the subcontractor's progress claims have been paid in full out of the trust account then the trustee/head contractor shall be entitled to retain any interest earned on

²⁸⁹ 1998 WALRC Report, pp. 63-64 at paras 3.32 & 3.33.

the fund in the period from the deposit into the fund of the owner's progress payment and the time at which the moneys are paid out to the subcontractor.

Investment income earned from the statutory trust account should not be some kind of legal Alsatia. Plainly the beneficiary has no strong claim to the interest on the fund not yet due to it even though interest will accrue. Therefore the Inquiry makes the recommendation that the head contractor be given the right to retain that money once it has ensured that all of the due and payable claims from the subcontractors have been met by payment out of the fund.

Another reason why in the view of the Inquiry the interest earned moneys should remain in the statutory construction trust until all moneys are paid out, is that it is conceptually possible, indeed it is not fanciful to envisage situations in which the amount of money paid by the principal into the statutory trust account will not be sufficient to pay all of the claims by the subcontractors. Such a situation could arise for example when a subcontractor has a valid claim upon the account though has not convinced an adjudicator under SOPA to include those amounts in the adjudicated sum. Nevertheless as was mentioned earlier in the Report, after the project has come to an end the subcontractor may be able to demonstrate that the adjudicator got it wrong in his or her interim adjudication and that it was entitled to the funds. If the statutory construction trust still contains within it interest earned from the progress payment, then that amount may go some way towards satisfying the claim of the subcontractor which has been validated by arbitration or court proceeding sometime after the project came to an end.

Bookkeeping

Books of accounts and records shall be maintained by the contractor trustee. These accounts would mirror the banking records of deposits into and payments out of the account.

The subcontractors' right to inspect the account

All subcontractors who have made claims for payment upon a head contractor will have the right to inspect the trust account records. This follows from their status as beneficiaries. A specific statutory amendment to that effect should overcome the doubts generated by such cases as *Avanes v. Marshall and Ors* (2007) NSWSC 191. In *Re Londonderry's Settlement* (1965) Ch 918, *Schmidt v. Rosewood Trust* (2003) 2A.C 709 and *Silkman v. Shakespeare Hanley Securities* (2011) NSW SC 148.²⁹⁰

²⁹⁰ See also Campbell, J.C., "Access by Trust Beneficiaries to Trustees' Documents Information and Reasons", paper based on one delivered at the NSW Supreme Court Judges' Conference on 23 August 2008, (available online at [http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/vwFiles/campbell230808.pdf/\\$file/ca](http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/vwFiles/campbell230808.pdf/$file/ca)

The costs of the statutory construction trust scheme

The Western Australian Law Reform Commission in its 1998 Report (1998 WALRC Report) referred to the New South Wales Security of Payment Committee claim that:

“...this can be demonstrated by the price reductions for direct payments from government on building contracts as compared to project costs on private contracts.”²⁹¹

The Andersen Report concluded from data collected by the NSW Royal Commission into the Building Industry that:

“the combined impact of late payment and default...equals 2.84% of total sub-contracted turnover.”²⁹²

Although the statutory amendment the Inquiry is recommending is not the equivalent of the Project Bank Account (PBA) system currently being employed on a voluntary basis for public works projects in the United Kingdom, the use of the PBA arrangement is in a sense comparable to the statutory construction trust which is recommended, particularly in so far as potential cost savings are concerned.

Those involved with the implementation of PBAs in the Home Office in London have estimated the overall savings brought about by the implementation of these accounts and the resultant payment to subcontractors in the industry is in the region of 2.5% per project with no impact on competitiveness. The United Kingdom Cabinet Office advised the Inquiry that feedback relating to the cost associated with the implementation of PBAs suggests that it is minimal.²⁹³

Rights of set-off

The work of the Inquiry in the formulation of its recommendations would be incomplete if it did not address the question of the principal seeking to set-off other funds owed to it by the head contractor. The question of set-off arises both in the general law contractual sense before insolvency and then again in the insolvency itself.

mpbell230808.pdf>); Gzell, I., “Recent decisions in relation to trusts and administration”, Paper presented at KPMG seminar on 22 April 2010, Melbourne; 20 April 2010, Sydney. For other cases, see also *Murray v Scheuder* [2009] WASC 51 and *Fay v Moramba Services Pty Ltd* [2009] NSWSC 1428.

²⁹¹ 1998 WALRC Report, p. 53 at para 3.16.

²⁹² 1993 Andersen Report, p. 9.

²⁹³ UK Cabinet Office advice dated 23/10/12 and 8/11/12.

Contractual set-off would arise when for example a principal had a right to claim liquidated damages from a contractor for delay. It is common in construction contracts for that situation to give rise to an entitlement in principle to deduct such damages from claims certified to be due to the contractor.

As Jenkins points out, a similar question will arise in an insolvency situation where in the event of the contractor insolvency if there was a trust account then there would be no set-off because the moneys would be paid to the subcontractor directly out of the trust account. If that happened, what would the consequence be in terms of the rights of the contractor for liquidation set-off?

The question can be best examined in the light of an example given by Jenkins:

“The sum allocated to a subcontractor out of the total sum certified is \$25,000. The subcontractor owes the contractor \$15,000 in respect of remedial works required to correct defects. The rules of liquidation set-off entitle the liquidator to pay only \$10,000 to the subcontractor and retain the balance as part of the asset for distribution among the unsecured creditors. Direct payment to the subcontractors of the entire \$25,000 deprives the liquidator of the opportunity to make the appropriate deduction and forces him to make a claim against the subcontractors for payment of the sums due.”²⁹⁴

Once again this difficulty does not arise in the model recommended by the Inquiry. The amount of money in the trust fund will not be susceptible to a claim by the liquidator.

Another example, again taken from the Jenkins analysis, is worthy of examination as it does have the capacity to impact upon the operation of the Inquiry’s recommended trust. Here Jenkins postulates the following situation:

“The total sum certified as due to the contractor is \$50,000, \$45,000 of which is allocated among the subcontractors. The contractor, however, due to his own fault, has not completed the works by the due date and the client is entitled to \$30,000 by way of liquidated damages. Can the client deduct \$30,000 from the trust account or, can he only have recourse to the \$10,000 attributed to the contractor?”²⁹⁵

In the first place the Jenkins example is not intended to be specifically referable to the recommendation made by the Inquiry as what is involved is a quite different kind of trust structure. However the Jenkins example is of considerable importance because it raises the question whether the amount of money to be paid *into* the trust fund in

²⁹⁴ Jenkins, J., “The Latham report trust fund proposals” (1995) 11 Construction Law Journal 262 at 268.

²⁹⁵ *Ibid*, p.269.

response to the head contractor's progress claim can legitimately be reduced by reducing the amount of money owing to the subcontractor, by reason of the head contractor's own default. This is an important question and one which warrants examination and answer when the utility of the construction trust as recommended by the Inquiry, falls under review.

Most contracts do contain such a provision. For example, the AS 4000-1997 (General Conditions of Contract) contains the following clauses:

Clause 34.7 (Liquidated Damages)

If WUC does not reach practical completion by the date for practical completion, the Superintendent shall certify, as due and payable to the Principal, liquidated damages in item 24 for every day after the date for practical completion to and including the earliest of the date of practical completion or termination of the Contract or the Principal taking WUC out of the hands of the Contractor.

Clause 34.9 (Delay Damages)

For every day the subject of an EOT for a compensable cause and for which the Contractor gives the Superintendent a claim for delay damages pursuant to subclause 41.1, damages certified by the Superintendent under subclause 41.3 shall be due and payable to the Contractor.

Clause 37.2 (Certificates)

The Superintendent shall, within 14 days after receiving such a progress claim, issue to the Principal and the Contractor:

- (a) a progress certificate evidencing the Superintendent's opinion of the moneys due from the Principal to the Contractor pursuant to the progress claim and reasons for any difference ('progress certificate'); and
- (b) a certificate evidencing the Superintendent's assessment of retention moneys and moneys due from the Contractor to the Principal pursuant to the Contract.

...The Principal shall within 7 days after receiving both such certificates, or within 21 days after the Superintendent receives the progress claim, pay to the Contractor the balance of the progress certificate after deducting retention moneys and setting off such of the certificate in paragraph (b) as the Principal elects to set off. If that setting off produces a negative balance, the Contractor shall pay that balance to the Principal within 7 days of receiving written notice thereof.

See also the NSW Roads Maritime Services version of a Project Alliance Agreement:

Clause 6.3 (Set-off)

- (a) Without prejudice to any other rights, RMS may deduct from any monies which may be, or become, payable to a NOP any money due from that NOP to RMS.
- (b) Nothing in this clause will affect the right of RMS to recover from the NOP the whole of any debt or any balance that remains owing by that NOP after deduction.

Clause 13.3 (Failure to Remedy)

If:

- (a) the Defaulting Participant fails within 7 Business Days after receiving a notice given under clause 13.2 to rectify a default; or
- (b) the Non-Defaulting Participants give notice under clause 13.2(b), the Non-Defaulting Participants may, as the Non-Defaulting Participants sole remedy,
- (c) where the Defaulting Participant is a NOP:
 - (i) wholly or partly suspend any payment due to the Defaulting Participant under this Agreement until the default has been remedied: ...

There are many more examples of contracts available that contain provisions of this kind.

It is fundamental to the construction trust proposal that the trust fund is established by payment from the principal of an amount legitimately owing under the head contractors progress claim. Therefore the principal only pays into what instantly becomes a trust fund, that amount of money that it is contractually obliged to pay to the head contractor. A river cannot rise above its source and in the event that there is a short-fall in the amount owed to subcontractors as a consequence of the principal exercising that contractual right, then that, unfortunately for the subcontractor, is the reality of the position.²⁹⁶

That is not as harsh as some might think because, as a corollary of the subcontractor carrying out 80% of the work, there is a high likelihood that if there is a claim for delay then the subcontractor might be implicated in that delay. But it is not necessary to speculate about such matters because there is simply no answer to the proposition that the principal only has to pay into the trust fund that which it legitimately owes to the head contractor. What would the alternative be? Would the alternative involve the

²⁹⁶ "Trust legislation is remedial, not magical. Trust legislation cannot create money where there is none. Trust legislation can only preserve and redistribute money in a fair and equitable manner." Letter from Canadian practitioner and author, Duncan Glaholt, Partner Glaholt LLP, Ontario Canada, to the Inquiry dated 15 November 2012.

principal forgoing its rights to impose liquidated damages upon the contractor? Surely not. It is inconceivable to suggest that the principal should be compelled to pay an additional amount into the trust fund in extinguishment of its rights to deduct liquidated damages from the head contractor. In all of those circumstances the answer to the question which has been posed by the Jenkins example, is that if by the combination of circumstances envisaged in the example, the amount of money to be paid to the head contractor is legitimately reduced, then that is the world in which the subcontractor operates.

In the view of the Inquiry the fact that this is yet another difficulty faced by a subcontractor in getting paid, in a curious way points to the advisability of insuring that in every other equitable way possible, the subcontractor shall be protected.

Set off was a question to which attention was given by the Law Reform Commission of Western Australia where the opinion was expressed:

“... a trustee could be allowed to set-off against trust funds due to the head contractor or a subcontractor any counter claim it may have against the contractor either in relation to the project or to any project.”²⁹⁷

The Law Reform Commission of Western Australia then goes on to refer to the position in a number of Canadian provinces, instancing Manitoba where the owner is required to pay the contractor:

*“...all sums justly owed to him in respect of the performance of the contract” but it is required to see that “provisions for the payment of other affected beneficiaries of the trust have been made”.*²⁹⁸

The Inquiry is of the opinion that the right of set off should be confined to the particular project

Arising out of the above discussion is the question whether or not the contractual right of set-off should be preserved. There is little use in pretending this is not an important question. The Inquiry has concluded that it would be an unwarranted intrusion into a long held right on the part of the principal to withhold payment of the full amount of a head contractor’s claim by exercising its contractual rights to withhold liquidated damages for delay.

²⁹⁷ See Law Reform Commission of Western Australia (P.G. Creighton, Chair), *Financial Protection in the Building and Construction Industry*, Discussion Paper No. 82, 1995, Law Reform Commission of Western Australia, Perth, p. 28.

²⁹⁸ *Ibid.* p. 28.

The Inquiry's reasons for having reached that conclusion are:

1. It is a long established right and it is no doubt a powerful incentive which has been bargained for, impelling the building contractor to meet the prescribed milestones in the contract.
2. The way in which those milestones are defined in the contract is usually by the employment of absolute terms. In other words the right to liquidated damages is defined as and accrued upon the failure of the contractor to meet the prescribed contractual target dates.
3. All construction contracts contain an extension of time provision which during the administration of the contract enables the building contractor to make claims for an extension of time to ward off potential liquidated damages. Most if not all building contracts require the contract administrator, the superintendent, the certifier, the project manager, or the owner to determine such extension of time within a reasonably short time during the occurrence of the contract to enable proper contract planning and administration to go ahead.

Where claims exceed the amount in the fund

How should the trustee approach the competing claims (assuming they are all valid) from subcontractors where the total claim exceeds the amount in the trust fund? Equity does have its rules to approach such a matter and the question is whether those rules should apply in the case of what is in effect a hybrid trust to which other obligations are relevant. The statutory obligation is for head contractors to pay subcontractors within 28 days as recommended by the Inquiry, and any disparity between the dates which the application of the 28 day limit establishes as the actual date for payment. That is to say, some of the subcontractors will be entitled to an earlier payment than others. The head contractor will pay in the order dictated by the date of receipt of the subcontractors' claims.

Payments out of the fund to the head contractor

The next problem which must be addressed by those examining the desirability of imposing a statutory construction trust, is the question of when the head contractor is entitled to pay out of the trust fund what is owing to it.

That can arise:

- i) generally and regardless of other surrounding circumstances; and
- ii) where there is a shortfall in the fund and that shortfall has been brought about by the owner having withheld liquidated damages.

On their faces these two questions provide quite different answers.

On the problem of shortfall, Ettinger postulates the following appraisal of the recommendations of the Alberta Taskforce for a statutory trust scheme:

“While the imposition of a trust undoubtedly provides greater assurance of payment, it cannot solve the problems which arise when there is a shortage of funds in the construction chain. A shortage may occur either because the contractor underbid the job, or the contractor fails to complete the project or complete it properly.

Where the contractor has underbid a job, there is little question that sub-trades and suppliers will bear the shortfall. In this situation the owner should not have to pay more than the contract price. The question is more difficult where there is a deficiency and the owner wishes to set off his damages against what is owing to the contractor. At first blush it appears that the principles involved should be the same, but somehow it is not as easy to justify the sub-trades and suppliers having to bear the loss while the owner never has to pay more than the contract price. It is a difficult problem because it is essentially the allocation of risk or deciding who will bear the loss. On one hand it seems reasonable that the sub-trades and suppliers should bear the loss because that is the risk of doing business. The purpose of builders’ lien legislation is to facilitate the flow of funds so as to improve one’s chance of being paid. The legislation does not, however, provide a guarantee of payment; it is not an insurance scheme. On the other hand, it is also possible to justify the loss being borne by the owner, if the contractor defaults, or the contractor, if a subcontractor defaults, because they are in a position to protect themselves by demanding from the contractor or subcontractor, as the case may be, a performance bond. Then, in the event of a deficiency, the loss is borne by the surety. As we have seen, in other provinces the issue has been resolved in favour of the owner and it is likely that Alberta will follow suit. It is not politically palatable to make the owner liable for more than the price for which he has contracted.”²⁹⁹

And in conclusion states:

“While the imposition of a trust scheme on the construction industry in Alberta will be of a great benefit to sub-trades and suppliers by ensuring that funds remain within the construction chain, the trust is unable to solve every problem. In the situation where there is a deficiency of funds the loss must be borne by one party or another. Even though the stated intention of builders’ lien legislation is to protect the interests of subcontractors, materialmen and labourers, where there is a deficiency of funds the loss usually falls on them.

²⁹⁹ Ettinger, L. P., “Trusts in the Construction Industry” (1988-1989) 27(3) *Alberta Law Review* 390 at 425.

The strength of the Task Force's Preliminary Report lies in its recommendation of registration for contractors and subcontractors and the requirement of a separate consolidated trust account. These two recommendations are unique in Canada and reflect a certain degree of boldness on the part of the Task Force. If implemented there should be fewer defalcations and fewer interruptions in the flow of moneys down the construction chain from which all involved should benefit, but especially sub-trades and suppliers. For this reason alone the recommendations of the Task Force should be given serious consideration."³⁰⁰

In the Inquiry's view, in the case of the shortfall brought about by a proper imposition of liquidated damages by the owner upon the head contractor, it is suggested that in those circumstances the contractor should not be entitled to pay itself in preference to the subcontractors. That is in accordance with the rules of equity which do not permit a trustee to prefer its position to that of the beneficiary.

However the answer to the first question does not fall out so readily.

Retention moneys: Reed Constructions Australia Pty Ltd: Should retention moneys be held in a separate trust account? If not, then.....?

At the request of the Inquiry, Mr Mark Robinson from the firm PPB Advisory, carried out an analysis of the books and records of Reed Constructions Australia Pty Ltd (RCA) as at the date of the appointment of Mr John Melliush and Mr Ryan Eagle of Ferrier Hodgson as voluntary administrators on 15 June 2012. Mr Robinson was appointed liquidator of RCA on 11 July 2012.

Mr Robinson concluded that \$7,117,279 was the total of the amounts recorded as "cash retentions" in the books and records of RCA. Mr Robinson concluded that:

*"Upon further investigation it is apparent that these monies had not in fact been held on trust by RCA. Rather, these funds have been used to fund working capital requirements on RCA projects and as at the date of appointment, the Company had no cash at bank."*³⁰¹

Mr Robinson went on to conclude that:

"the requirement for a head contracting company to establish a "statutory construction trust account" and deposit any cash retained from progress payments made to sub-contractors would provide a mechanism to separately

³⁰⁰ Ibid, p.429.

³⁰¹ Advice to Inquiry dated 13 November 2012.

record, account and secure cash retentions on behalf of sub-contractors. However,.....such a regime would probably limit contractors access to bank funding.”³⁰²

He then stated that:

“For a trust account regime to work effectively, there would also need to be:

- *An independent verification and reporting process (otherwise the trust funds would simply be applied to third parties, as occurred in RCA);*
- *A detailed outline (auditable trail) of whom the monies were held on behalf and for which project;*
- *Material repercussions for failure to comply, including rectification mechanisms.*”³⁰³

Mr Robinson then went on to say that:

*“...an existing established guideline which could be used as the current requirements relating to trust funds held by real estate agents, which in NSW is governed under the Property Stock and Business Agents Act 2002.”*³⁰⁴

As Mr Robinson highlighted, real estate agents are obliged to report on moneys they hold in trust. Government, through its Office of Fair Trading, a division of the Department of Finance and Services, also has powers to respond to complaints concerning the application of trust funds. As Mr Robinson also made the observation that *“early warning mechanisms”*.....minimise the chance of *“a build-up of misappropriation.”*

Further, on the notion of holding retention moneys in trust, Canadian lawyer and legal commentator Duncan Glaholt states:

*“If the retention is money earned by others and held by me, it is not my money. If I profit by holding someone else’s money (whether by using it as a cheap source of financing, or putting it to work at interest) I should: a) account for that profit to the person who is entitled to the money, and b) disgorge that profit to the person or persons whose money it is. The money is in no sense “mine”. This principle underpins the entire Part II scheme in Ontario: pay your workers and material suppliers first instead of using them as your private, interest-free bank.”*³⁰⁵

³⁰² Ibid.

³⁰³ Ibid.

³⁰⁴ Ibid.

³⁰⁵ Duncan Glaholt, 15 November 2012.

In light of the above, it is the Inquiry's recommendation that retention moneys should be deposited and kept in the construction trust account.

Contractor education

Although speaking in relation to the entirely different Latham Report Trust, Jenkins points out that:

“Intended trustees will need to be aware of their duties as trustees. Such duties are imposed both by statute and case law and are rigorous. The unwary might find themselves exposed to claim for damages for breach of trust.

The terms of the trust need to be clearly spelt out and clear rules should be imposed for the opening and operation of trust accounts pursuant to the proposal so that the bank is on full notice of the trust nature of the account. If the account is opened simply in the name of the client without being specifically designated as a trust account then there is a risk that the bank will be free to treat any credit balance on the accounts as the funds of the client and may exercise legitimate rights agreed as part of its contractual arrangement with the client to set the money off against debt balances on other accounts”³⁰⁶.

Each of those cautions has been taken into account by the Inquiry and each has been appropriately dealt with. None of them in the view of the Inquiry, operate as any kind of disincentive or impediment to the implementation of the construction trust account recommendation.

The Inquiry recognises that there may be a need to amend some standard form of contract to recognise and implement the introduction of the statutory trust and of course the industry will turn to its legal professionals to amend bespoke contracts accordingly.

In the view of the Inquiry neither of those two circumstances are of any real concern. They reflect processes that are going on continually in any event and the tasks themselves have not proven to be difficult in Canada or the United States and neither can it be concluded upon the basis of an intrinsic analysis that such tasks could be difficult. All turns on the terms of the statute and like anything else once a statute becomes law then it follows that those affected will be required to alter their conduct accordingly. Such an adjustment in the view of the Inquiry is not likely to be of any great significance and is certainly not seen as an impediment to the introduction of the proposal from a legal or practical view point.

³⁰⁶ Jenkins, J., “The Latham report trust fund proposals” (1995) 11 *Construction Law Journal* 262 at 266.

Sensible questions concerning the trust³⁰⁷

1) Is a set-off against trust funds permitted?

Yes but only a set off in respect of amounts referable to the particular project. This is in keeping with the parties right to contract for a set off and the Inquiry's conclusion that protection to subcontractors requires that funds not be directed away from the project.

2) What happens when the trustee does become insolvent as is envisaged in the circumstances under analysis?

A fundamental maxim of equity is that a trust will not fail for want of a trustee. The Court has an inherent jurisdiction, arising from its general jurisdiction to supervise trusts and trustees, to step in and appoint trustees to carry out the trust if the settlor has omitted to appoint a trustee or if the trustees appointed refuse to act, are dead or become incapable of acting.³⁰⁸

In NSW, the Court's inherent power of appointment of trustees is codified in section 70 of the *Trustee Act 1925* (NSW) which provides:

70 New trustees

- (1) The Court may make an order for the appointment of a new trustee or new trustees either in substitution for or in addition to any existing trustee or trustees, or although there is no existing trustee.
- (2) The appointment may be made whenever it is expedient to appoint a new trustee or new trustees, and it is inexpedient difficult or impracticable so to do without the assistance of the Court.
- (3) In particular and without prejudice to the generality of any other provision of this section, the Court may make an order for the appointment of a new trustee in substitution for a trustee who is convicted of a serious indictable offence, or is a bankrupt, or being a corporation is in liquidation or is dissolved.
- (4) In the case of any trust for a charity the Court may make an order for the appointment of a new trustee on such evidence of the trust as the Court deems sufficient.

³⁰⁷ The answer to these questions will identify and demonstrate whether or not the answer itself must be included in and consist of legislation or be supplemented by legislation.

³⁰⁸ *Sinnott v Hockin* (1882) 8 VLR (E) 205at 210; *Stevedoring Employees Retirement Fund Pty Ltd v The Association of Employers of Waterside Labour* (unreported, Sup Ct, NSW, No 4739 of 1994, 1 March 1995).

- (5) This section shall be deemed to authorise the Court to make an order for the reappointment of the continuing trustees alone as new trustees.
- (6) An order under this section, and any consequential vesting order or conveyance, shall not operate further or otherwise as a discharge to any former or continuing trustee than an appointment of new trustees under any power for that purpose contained in any instrument would have operated.
- (7) [Repealed]
- (8) Every trustee appointed under this section shall, as well before as after the trust property becomes vested in the trustee, have the same powers authorities and discretions, and may in all respects act as if the trustee had been originally appointed a trustee by the instrument, if any, creating the trust.
- (9) Nothing in this section shall give power to appoint an executor or administrator.

Although it has not been mentioned in any of the generalised criticisms of the construction trust it must be acknowledged that it will be necessary for an application to be made to the court for a replacement trustee to take the position of the insolvent contractor who to that point had been the trustee. That will involve additional administrative and legal costs, however it is a simple matter to make particular provision in the legislation for a simple application to be made to a Master in Chambers in the equity division who would be empowered to dispense with the requirement that all beneficiaries be formally made parties and be required to attend at court.

It would not of course always be necessary to apply to the court to appoint a new trustee. If for example the whole of the trust fund in respect of which the soon to become insolvent trustee has been properly disbursed in accordance with the trust, then the new trustee will be automatically appointed in the sense that when the owner contracts with a new contractor and moneys are paid to that new contractor it will by virtual of the operation of the statute itself, automatically become the trustee.

3) **What rights of information are available to beneficiaries?**

All subcontractors who have made claims for payment upon a contractor will have the right to inspect the trust account records. This follows from their status as beneficiaries. A specific statutory amendment to that effect should overcome the doubts generated by such cases as *Avanes v. Marshall and Ors* (2007) NSWSC 191. In *Re Londonderry's Settlement* (1965) Ch 918, *Schmidt v. Rosewood Trust*

(2003) 2A.C 709 and *Silkman v. Shakespeare Hanley Securities* (2011) NSW SC 148.³⁰⁹

4) **Can beneficiaries assign their rights in the trust fund?**

Yes

5) **Is a trust deed required?**

No

6) **What are the powers of the trustee?**

The powers of the trustee are to:

- (i) pay the payments by the principal into a separated designated trust account if they elect to do so after the initial payment by the principal;
- (ii) determine, certify or agree, as the case may be, whether and of what moneys are due and payable to subcontractors;³¹⁰
- (iii) pay moneys out of the fund to subcontractors that are due and payable;
- (iv) invest the funds in NSW *Trustee Act 1925* authorised investments;
- (v) pay to itself the balance of moneys in the account after the subcontractors have been paid.

7) **What are the duties of the trustee?**

The duties of the trustee are to:

- (i) review, agree, certify and pay on subcontractors progress payment claims;

³⁰⁹ See also Campbell, J.C., "Access by Trust Beneficiaries to Trustees' Documents Information and Reasons", Paper based on one delivered at the NSW Supreme Court Judges' Conference on 23 August 2008, (available online at <[http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/vwFiles/campbell230808.pdf/\\$file/campbell230808.pdf](http://www.lawlink.nsw.gov.au/lawlink/Supreme_Court/ll_sc.nsf/vwFiles/campbell230808.pdf/$file/campbell230808.pdf)>); Gzell, I., "Recent decisions in relation to trusts and administration", Paper presented at KPMG seminar on 22 April 2010, Melbourne; 20 April 2010, Sydney. For other cases, see also *Murray v Scheuder* [2009] WASC 51 and *Fay v Moramba Services Pty Ltd* [2009] NSWSC 1428.

³¹⁰ An example of coalescence of contractual duties and trustee powers.

(ii) pay what is due and payable;

(iii) provide information when requested by a beneficiary.

8) **Should or does the statutory construction trust pick up not only payments made under a contract but later claims for a quantum meruit or restitution?**

Yes because such sums include work which has been carried out by subcontractors.

9) **What about an advance payment?**

Yes because the terms of the recommended new section refer to the head contractor receiving moneys 'on account' of work to be done by subcontractors.

10) **What about damages?**

No they are not included.

11) **Can overheads be paid out of trust funds?**

Yes but only if due and payable in accordance with the payment regime under the head contract and only when the subcontractors have been paid.

12) **What constitutes a breach of trust?**

Failure to pay what is due and payable to subcontractors and payment out of the trust account for any non-trust purpose.

13) **What about set-off?**

It has been decided in Canada that when funds come into the hands of a trustee under the statutory trust provision, they constitute a fund for the benefit of the creditor who is next in line in the chain. The funds cannot be diverted or applied to any set-off of unrelated debts nor to unliquidated claims outside of the contracting issue.³¹¹

³¹¹See *Harding Carpets Limited v St John Tile & Terrazzo Co* 1988 68 CBR (NS) 196, 49 DLR (4th) 311 (New Brunswick).

Moneys in the trust account cannot be defeated by demands made under the *Income Tax Act* and *Excise Tax Act* see *Modular Product Limited v Aristocratic Plywood Limited* 1974 2 WWR 90, 42 DLR (3d) 617 (British Columbia).

- 14) **What happens if head contractors set up residences or obtain finance from outside the relevant states where the legislation applies in attempt to evade the requirements of the scheme?**³¹²

The answer is provided by the Western Australian Law Reform Commission and by the 1996 Price Waterhouse Report, to the effect that such a move could be countered by appropriately worded legislation. The Inquiry respectfully agrees with that expression of the position and does not see that the question presents any difficulty for the smooth operation of the statutory construction trust.

- 15) **What happens if there is an insolvency of one or more beneficiaries?**³¹³

The 1996 Price Waterhouse Report correctly identified that the effect of bankruptcy or insolvency of a beneficiary will depend on the structure of the trust. It states:

If there is a "privity of trust" approach adopted as to the structure of the trust (Canadian approach), then an insolvent beneficiary higher up the contractual chain may "block" the flow of funds down the chain to those below, who will then have to wait for an insolvency administrator to be appointed and then perhaps dispute their entitlement to the monies received by the administrator.

On the other hand, if there is a cascading trust, where monies are held for all those down the chain, then the insolvency of a co-beneficiary will not impinge upon the distribution of funds to the other beneficiaries.³¹⁴

What this overlooks is that the funds will only be paid into the segregated trust account in the principal. The moneys do not become a part of any insolvency and will not include the trust fund.

³¹² This question has been taken directly from the 1996 Price Waterhouse Report, see p. 38, para 4.7.7.

³¹³ Again this question has been taken directly from the 1996 Price Waterhouse Report, see p. 38, para 4.7.8.

³¹⁴ *Ibid.*

- 16) **Would such a trust be a trading trust and run into the sorts of problems thrown up by Sections 556 and 443 of the Corporations Law and Section 109 of the Bankruptcy Act?**

No. The Trust does not trade. It is a payment only trust.

- 17) **How to distribute the trust funds?**

This may happen in a variety of ways depending upon the contract form adopted by the parties. Certification of completion of various phases of the construction and building process are made in some contracts by architects, quantity surveyors or superintendents.

The parties may agree what is due or SOPA may adjudicate if there is a dispute.

- 18) **How would a trustee distribute funds available for distribution when those funds are not sufficient to pay all amounts owing to subcontractors? Should the trustee distribute those funds on a first in and best dressed basis or upon a pari passu basis?**

Directions could be given to a Trustee by the court but in the view of Price Waterhouse “*having regard to the principles of equity it would seem that a pari passu basis of distribution would be preferable.*”³¹⁵

As Ettinger neatly explains on the topic of “Distribution of Funds”:

“Substantial litigation has also arisen with respect to the obligations of the builders’ lien trustee in distributing trust funds to the beneficiaries. The present builders’ statutes provide no direction with respect to distribution and one would assume, therefore, that since a discretion is not expressly conferred, the duty of the trustee is to maintain an even hand among the beneficiaries. The Supreme Court of Canada determined that this was not the case, however, in Minneapolis-Honeywell Regulator Co. Ltd. v. Empire Brass Manufacturing Co. Ltd. Mr. Justice Rand, speaking for the majority, stated that “Section 19 (of the B.C. Mechanics Lien Act) does not, however, require that [the trust moneys] be distributed on a pro rata basis. The subcontractor has, in this respect, a discretionary power, and his obligation is satisfied when the trust moneys are paid out to persons entitled, whenever the division. Such a discretion is certainly not expressly set out in the statute, but may be implied by

³¹⁵ Ibid.

the nature of the construction industry. As explained by Mr. Justice Smily of the Ontario Supreme Court in Re Putherbough Construction Company Limited,

... it would be impractical to require the contractor to pay the proceeds of the contract rateably to the beneficiaries mentioned and specified ... during the ordinary course of construction ... a contractor makes payments to creditors in the ordinary course of business and naturally he could not be expected to be called to account for those payments in the case of a late deficiency nor could the creditors who were entitled to receive payment, that is who are beneficiaries of the fund, be expected to return such payments. Business could not be carried on in such uncertainty as requirements of that nature would entail or create.

This means that contractors must be able to pay their subcontractors and suppliers as the work proceeds and not be in breach of the trust even if some beneficiaries end up not being paid in full. As long as the contractor has paid out all the trust funds to trust beneficiaries, he will have discharged his trust obligations. The alternative would be for the contractor to withhold payment from all beneficiaries until the end of construction when he could be sure of ascertaining all the beneficiaries and their pro rata portion. This would be a commercially unacceptable impediment to the flow of funds and, one would assume, contrary to the intent of the legislation.”³¹⁶

Discussion of the construction trust in New South Wales

Following the establishment of the Gyles Royal Commission and lobbying within the construction industry, the Security of Payments Committee (SOPC) was formed in November 1991 and requested to submit a proposal as to how payments within all levels of the building and construction industry supply chain could be made more secure and timely. In December 1992, the SOPC’s proposal for the implementation of a legislated deemed trust was submitted to the NSW Government.

Recommendations of the Business and Consumer Affairs Agency

The Inquiry will begin the analysis of the discussion concerning the construction trust with an examination of what happened in NSW in 1990/91 where, at the end of a close analysis of problems remarkably similar, if not identical, to those which have given rise to the establishment of the present Inquiry, the NSW Business and Consumer Affairs Agency (BCA) published an Issues Paper which outlined the various options it had

³¹⁶ Ettinger, L. P., “Trusts in the Construction Industry” (1988-1989) 27(3) *Alberta Law Review* 390 at 403.

considered as a means of improving the financial protection of subcontractors.³¹⁷ Among the eight options that had been considered, two proposals centred on a trust arrangement, namely:

- The enactment in NSW of trust/lien legislation on the model of the Canadian Alberta proposed legislation; or
- The enactment in NSW of legislation providing for mandatory trusts such as in the trust provisions for retention funds provided for in the current standard form building industry contracts.³¹⁸

BCA's considerations as to the adoption of mandatory trusts for NSW are of sufficient importance to warrant being set out in full for the convenience of readers who are therefore not required to seek out copies of the report and those extracts are set out below. Before doing so it is well worth noting that the then NSW opposition was in favour of the mandatory establishment of such trust funds³¹⁹ and the South Australian select Parliamentary Committee Report also stated that it was in favour of such a proposal.³²⁰

That report carefully assessed the construction trust under the heading "Considerations as to adoption of mandatory trusts for New South Wales" and concluded:

*"Mandatory trust provisions in building contracts are an option which would seem an acceptable solution to the building industry, including BISCOA."*³²¹

In considering whether to recommend the adoption of mandatory trusts for NSW, the BAC set out the following comments in its analysis:

CONSIDERATIONS AS TO ADOPTION OF MANDATORY TRUSTS FOR NSW

9. Mandatory trust provisions in building contracts are an option which would seem an acceptable solution to the building industry, including BISCOA.
- 9.1 At present, there are standard form subcontractor contracts which provide for the main contractor to hold retention funds in a trust fund in favour of the subcontractor. Thereby a proportion of the subcontractors' monies are secured in the event of financial failure of the main contractor.

³¹⁷ Business and Consumer Affairs, (1991) *Issues Paper on Financial Protection for Building Subcontractors*. New South Wales. Business and Consumer Affairs Agency, Sydney ("1991 B&CA Issues Paper").

³¹⁸ *Ibid*, para 6.

³¹⁹ *Ibid*, para 9.7.

³²⁰ *Ibid*, para 9.8.

³²¹ *Ibid*, para 9.

- 9.2 As well, the BSC currently administers trust funds in owner/licenced builder disputes. Accordingly at least for domestic building, the BSC existing mechanism could be used.
- 9.3 It appears that currently many main contractors pressure subcontractors into excluding these trust provisions in contracts by threatening to go to another subcontractor who will delete the trusts provision.
- 9.4 If the current industry-agreed-on provisions for setting up of trusts by a main contractor in favour of a subcontractor were made mandatory, exclusion of such a provision would cease to be a bargaining point.
- 9.5 The standard form subcontractor contracts have the appeal that they are agreed upon by the industry.
- 9.6 The standard form would have to be amended to cover all money owing to the subcontractor, not as at present, simply retention funds.
- 9.7 The NSW Opposition is in favour of mandatory establishment of such trusts funds.
- 9.8 The South Australia Select Parliament Committee Report considered the concept of protection of subcontractors by trusts. They stated that two schemes had been canvassed – a central fund and individual builder funds for each project – and raised significant problems.
The Committee stated:
“There is nothing to prevent provisions setting up trust accounts from being included in standard building contracts ... (and) it would be appropriate and desirable for the industry to self regulate such change”.
Informally, it is understood that the SA Government Industry Working Party, established subsequent to the South Australian Select Parliamentary Committee Report, rejected trusts as a solution on the grounds that supervising establishment of same was unworkable.³²² However, NSW does not have universal builders’ licensing as does SA. Therefore, NSW does not have the option at present of extending insurance against financial failure to all builders to ensure subcontractors get paid.
- 9.9 Compared to the other options raised in this paper, the possibility of enacting legislation to make mandatory a trust clause in favour of subcontractors would be relatively uncontentious. Nevertheless, it should be noted that there still may be opposition from other interest groups. The trust clause would be inserted in every subcontractor contract and would be to the effect that the main contractor hold all monies received from the owner in respect of subcontractor work in the trust for the subcontractor. The definition of “subcontractor” should be wider than currently generally accepted by industry and cover all who are not indirect contractual nexus with the project owners for example, professionals who provide service to the main contractor rather than as a principal in contract with the owner.
- 9.10 Any such legislation should be reinforced by substantial pecuniary penalties for non-compliance imposed on all knowingly concerned in the non-compliance.

³²² This unsupported generalisation is reminiscent of the Andersen Report. The Inquiry does not consider that it is sound. Nor is it evidence based.

- 9.11 If subcontractor trusts were made mandatory, it is considered desirable that the BSC should ensure compliance and carry out random checks to ensure trusts accounts are set up. The BSC should be given the power to prosecute for breaches of the legislation.
- 9.12 Making trust provisions mandatory and subject to penalty for non compliance should alleviate the problem highlighted by the case of KBH v Lidco, of breach of contractual conditions for trusts.”(footnotes excluded)³²³

In its advice to the then NSW Minister for Business and Consumer Affairs Mr Gerry Peacocke, the BCA recommended that:

- “... the following options be explored by liaison with interested parties:
- i) No enactment of lien legislation in NSW.
 - ii) Enactment of legislation to make mandatory a trust provision in subcontractors’ contracts, on the model of the current retention fund trust clauses in the current building industry standard form contracts.
 - iii) Extension of the BSC Insurance Scheme which commenced 4 February, 1991 for BSC licensees to a more realistic level than \$1000. Such a raise in cover would be funded by an annual appropriate levy on licensees.
 - iv) Examination of funding options for ongoing education programmes for BISCOA members as to contractual rights, obligations, tendering techniques and the like.”³²⁴

The Inquiry agrees in principle with the recommendation made by the BCA in 1991 and agrees with the continuing need for the establishment of such a statutory construction trust.³²⁵

At or about that time there was intense lobbying activities from subcontractors which gave rise to SOPA and it appears that the statutory construction trust fell from view at least for the time being.

The Gyles Royal Commission

The Gyles Royal Commission did not specifically address or make any recommendations in respect of the construction trust proposal. Notwithstanding this, in its 1992 Report, the Gyles Royal Commission made considerable headway at that time to highlight payment problems facing subcontractors in the building and construction industry and the issue of insolvency.

As part of its analytical review of “20 Major Projects” across Metropolitan Sydney between 1990 and 1992³²⁶, the Gyles Royal Commission paid considerable regard to the

³²³1991 B&CA Issues Paper, pp.9-10, Section 9.

³²⁴1991 BCA Issues Paper, p.13, para 15.

³²⁵Subject to comments that follow with the form in which it is suggested the trust should take shape.

plight of the subcontractor. In its Analytical Issues Paper on “Subcontractors”³²⁷, the Commission noted the “*omnipresent*” role that subcontractors played in the construction industry at that time.³²⁸

The Commission found that some 1893 subcontractors were engaged with an average of 60 per cent of the final contract cost spent on subcontracting. Translated into the number of hours worked on site over the full construction period, this amounted to on average, 81 per cent of the work.³²⁹

Looking at the role of the subcontractor, the Gyles Report concluded that:

- “5.1 The role of the subcontractor in the delivery process on Major Projects extends beyond the mere provision of labour for the physical execution of some 80% of the work. It is submitted that the subcontractor in his time plays many roles, for and on behalf of the client, the superintendent, the design team and most importantly, the builder.*
- 5.2 Some of these roles are a creative redistribution of responsibility “down the line”. Other roles have been taken up by Subcontractors in abrogation by the other players of their essential role in the delivery process. It is important to recognise them and how they impact on the delivery.”³³⁰*

The Gyles Report then proceeded to list and comment on what it found to be the multifaceted roles of the subcontractor - being, “The Subcontractor as Designer”, “The Subcontractor as Marketer”, “The Subcontractor as Building Estimator”, “The Subcontractor as Banker”, “The Subcontractor as Cost Controller”, “The Subcontractor as Programmer”, “The Subcontractor as Building Manager”, “The Subcontractor as Builder”, “The Subcontractor in Industrial Relations”, “The Subcontractor under Nomination”.

On the topic of “The Subcontractor as Banker”, the observations are telling:

9.1. By Progress Payment

9.1 1. There is a very real sense in which the subcontractor bankrolls the builder on any contract. The “Cashflow and Project Performance” paper has shown how punctilious the builder is in submitting and being paid his monthly progress claim. Most contracts require the builder to certify (even by statutory

³²⁶ The Major Projects Analytical Issues Papers and Final Paper are found in the Gyles Report, Vol 9.

³²⁷ Gyles Report, Vol 9, Appendix PR8.1.6 entitled “Major Projects Analytical Issues Paper: Subcontractors”, pp. 137

³²⁸ Gyles Report, Vol 9, p.140 at 2.1.

³²⁹ Gyles Report, Vol 9, p.141-142 at 4.1.

³³⁰ Gyles Report, Volume 9, p.144 at 5.1 and 5.2.

declaration) that all men on site, all suppliers and subcontractors have been paid monies owing to them for work done pursuant to the progress claim. **This requirement is nearly always taken lightly.** The builder may well have a clause in his head contract which grants him interest on late payments by the client, but this is never translated into a similar concession for the subcontractor.

9.1.2. It is a fact that the direct employees on site are paid in timely fashion due to union pressure. The suppliers are paid in good time if their materials are needed urgently on the subject site or other project in the ensuing period. The subcontractor payment is deferred for a regular 90 days or more; and is discounted wherever possible by contra-charges, delayed approval of variations, rapid approval of contract deletions and by cash retentions. **These actions seem to be taken even when it is obvious that the main expense to the subcontractor is a weekly wage bill.** In respect of approval of variations the builder always has the let-out that the client has not yet granted its approval, even if the subcontractor was instructed by the builder to do the work and it has in fact been completed.

9.1.3. Effectively the builder creates project liquidity by delaying payment to the subcontractor (and by overclaiming where possible). The only effective redress by the subcontractor is to load up the price to cover the cost of providing “finance”. Judging by the survival rate of subcontractors, this loading, among the other loadings being highlighted in this paper, is effective.

9.1.4. On occasion a builder may act as banker for a subcontractor in the provision of materials for a skilled trade such as formwork, when the labour skills of the subcontractor are keenly desired. Or say carpet where there is a desire to pay storage in order to obtain an early delivery and offset the reality of rise/fall or the risk of poor pattern matching late in the contract. Usually however, a builder will only finance a subcontractor when that entity is facing insolvency and its demise would be a greater financial burden than the pre-payment.

9.2. By Nature of Security

9.2.1. The two common forms of security for performance are Cash Retention and Bank Guarantee.

9.2.2. Cash Retentions are sums deducted from regular progress payments, accumulated to form a prescribed percentage of the contract sum, usually 5%, and then released in stages after project practical completion and final completion.

9.2.3. Bank Guarantees are undertakings given by the subcontractor's bank which provide the principal with a guaranteed sum, usually 5%, which it can draw from in part or wholly should the sub-contractor default in his contractual obligations causing financial loss to the principal.

9.2.4. Cash retentions usually take the form of a 10% deduction from each payment until the accumulated value reaches a maximum of 5% of the contract sum. **The criticism subcontractors have of this form of security is that the control of the retained funds goes from them to the builder. This places the funds at risk of being lost if the builder becomes insolvent, as retentions are normally the last matters dealt with by the receiver. It also reduces operating funds the subcontractor would normally have for meeting debts. Subcontractors argue that the recipients of these cash retentions use them to invest on the short term money market, or as guarantees to commence new work or meet short term credit debts. The recipient reaps all the benefits of the retention sum, which really belongs to the subcontractor.**

9.2.5. Bank Guarantees serve the same purpose as cash retentions with the exception that they cause no reduction in cashflow from deductions made from progress payments. Some banks give guarantees on the strength of the assets owned by the subcontractor, **however if insufficient assets are controlled they normally require an equivalent sum from the subcontractor to be maintained with the bank.** This permits the subcontractor to earn interest on the invested funds and there is no risk if the head contractor becomes insolvent. The main disadvantage is that the subcontractor may need to have the funds prior to commencing the work to cover the guarantee. The advantage the bank guarantee allows the head contractor is that, should the subcontractor become insolvent, there is a chance that he may call upon the guarantee to cover any losses. This is generally unlikely considering the position taken by the receiver.

9.2.6. The argument is divided as to which form of security is most commonly adopted. It becomes obvious that established firms that have the financial capacity to take out bank guarantees probably do so, and those that do not, would use cash retentions. **There is very little argument however that there is a basic instability in the process of the subcontractor acting as banker or financier for the builder.**³³¹
(emphasis added)

The Gyles Report also looked at the issue of insolvency and in the Final Report stated:

³³¹Gyles Report, Volume 9, p.150-152, Section 9, "The Subcontractor as Banker".

“...There is a good deal of impetus for some form of security of payments legislation. Whilst I have not had the time to devote to the topic that I would like, I have not yet been persuaded that there is a case for legislative intervention or the form it should take. It should also be borne in mind that this is essentially a Federal Government field and State attempts to grant special privileges to sectors of the industry are unlikely to be successful.

I do, however, recommend that the State Government do what it can to support the proposition that unpaid wages should rank ahead of taxes on insolvency.”³³²

In 1996, Mr Gyles QC who chaired the 1992 Royal Commission was requested to provide an opinion on the SOPC Trust Proposal and the constitutional validity of that proposal. The former Commissioner, in summary, advised that:

- leaving policy questions to one side, the trust concept as a basic principle is sound; and
- constitutional issues relating to bankrupt and corporation law would not invalidate the SOPC proposal.³³³

It is not the task of this Inquiry to resurrect and harness political memory and it is not clear whether SOPA was considered to be an effective alternative for the statutory construction trust. Whatever view was taken of the nature of the SOPA reforms, plainly for the reasons that follow, they could never have properly been regarded as an effective alternative because they do not address the protection of subcontractor payments at different times, in different circumstances and after an insolvency has occurred. There is no point in speculating whether or not the introduction of SOPA was the reason for an apparent loss of interest in the statutory construction trust and as has been said above, it is not considered to be useful to engage in an exercise in political archaeology.

1996 NSW Discussion Paper (NSW Green Paper)

“NSW Security of Payment Committee deemed trust proposal

This proposal has been the subject of two independent reviews:

- *The Andersen Consulting Review commissioned by the NSW Department of Industrial Relation, Employment, Training and Further Education (1993).*
- *Price Waterhouse Report commissioned by the National Public Works Council (1996).*

³³²Gyles Report, Volume 9, p.111, Chapter 15, “Insolvency”.

³³³Coopers and Lybrand Report, p.18.

Each of the above reviews cast major doubts on the viability of the proposed scheme. The scheme has potential hidden costs and generally the legal status of trusts in themselves were not seen as a problem. However, the reports concluded that the complexities associated with the mixing of trust moneys with other funds of a contractor, together with the impact of other existing regulations/laws on the status of such moneys, would inevitably result in a costly and complex dispute process. Therefore, recovery of trust funds in the event of insolvency is extremely unlikely, while existing legal remedies are available for recovery if insolvency is not at issue.

The practical benefit of trusts as proposed by the Security of Payment Review Committee was seen as having a strict regime in place to punish those who fail to pay and therefore breached their trust obligations.

Any such additional punitive regime is not considered appropriate at this stage, particularly in view of the Government's recent revision of the Oaths Act (see section 4.2) and the Contractors' Debts Act (see section 4.3), the amendments by the former Federal Government of the Corporations law which imposes much greater liabilities onto company directors in relation to their corporate behaviour, and the many other existing legal forums available for relief.”³³⁴

The Inquiry makes the following observations in response:

- the Andersen Report may be disregarded for the reasons addressed later in this Report;
- the Price Waterhouse Report is in fact highly supportive of the trust;
- the so called “hidden costs” have remained hidden after more than 20 years;
- The dispute resolution process has been later put in place through SOPA;
- the conclusion “... recovery of trust funds in the event of insolvency is extremely unlikely” is a dangerous solecism which should be disregarded;
- the Green Paper adds nothing of value to the debate; and
- it merely recycles errors.

³³⁴ 1996 NSW Green Paper.

The advantages of the statutory construction trust

*“In the unique and complex world of construction, the bankruptcy of one project player may have devastating results on the pocketbooks of other parties to a particular construction venture. When one party falls into financial difficulty, every other party in the contract can be affected, particularly those in direct contractual privity. The most frightening example of such negative externalities of an upstream entity’s bankruptcy occurs when one party is paid with funds intended to satisfy future obligations on downstream contracts. Even before the consideration of bankruptcy, the contractor must somehow save enough money to pay off its subcontractors when subcontracts become payable in the future. However, what happens if the prime contractor goes into bankruptcy prior to these downstream payments? The answer in some jurisdictions is that the downstream parties are forced to accept only a portion of the money that has been essentially earmarked for their benefit by the prime contractors. Through the use of statutory, express, and constructive trusts, other jurisdictions in the United States are mandating the correct resolution to this problem. When funds held by a bankrupt contractor that are intended to pay subcontractors **are held in trust by the contractors, the funds do not become property of the bankruptcy estate, and the subcontractor is paid in full for the improvements he has made to the owner’s property.**”³³⁵*

(emphasis added)

The Western Australian Law Reform Commission Report of March 1998, (the WALRC Report) concluded that the statutory construction trust had the following advantages (selected footnotes included):³³⁶

[1] *It provides a means of ensuring that a head contractor and subcontractors are paid for their services and for materials supplied while keeping contract moneys within the control of the parties to the project.*³³⁷

[2] *It imposes ethical standards on the payment of participants in the industry for work done or materials supplied in an industry which has failed to use self-regulation to control the use of various unfair or unscrupulous practices.*

³³⁵ Collier, K.W., “The Nuts and Bolts of Bankruptcy, Trust Funds, and the Construction Industry: Building a Solution for Subcontractors Nailed with an Unpaid Bill (2004-2005) 21(2) *Emory Bankruptcy Developments Journal* 623 at 623

³³⁶ Entitled “Project No 82 Financial Protection in the Building and Construction Industry”. Relevant sections are reproduced in the appendix to this Chapter.

³³⁷ It is also interesting to note that the Australian Banking Association and the Australian Finance Conference each of which gave evidence to the NSW Security of Payment Committee expressed the opinion that one of the advantages of the trust approach was “the prevention of the divergence of funds from one project to another...” (See the reproduction of that material at page 55 of the Australian Law Reform Commission Report at para 3.19.)

[3] *It reinforces good practice in the distribution of funds for a project to the participants in the project and is consistent with the concept of cooperative contracting, which is seen as way of improving the efficiency of the industry.*

[4] *Because the moneys are held in trust, they cannot be seized or frozen by a receiver or liquidator of the trustee or the trustee of the estate of a bankrupt trustee.*³³⁸

[5] *This means that the position of a person further down the chain can be secured and the payment of funds downward can still take place because the project funds held in trust will not form part of property distributed in the bankruptcy or winding up of the trustee.*

[6] *A wider range of remedies is available for a breach or possible breach of trust than for a breach of contract.*³³⁹

[7] *It may result in a speedier resolution of disputes between, for example, a head contractor and a subcontractor, because generally the head contractor cannot withdraw money from the trust fund until all the claims of the fund's beneficiaries have been met.*

[8] *It removes the incentive for those holding funds to create artificial disputes and resolve them through purely commercial pressure.*

[9] *For the same reason, it may result in speedier payment of subcontractors.*³⁴⁰

Further advantages of the construction trust

To those listed advantages may be added the following:

In the evidence given by Mr John Melliush of Ferrier Hodgson he expressed the view that:

³³⁸ Bankruptcy Act 1966 (Cth), s 116(2)(a). See also Ford, H.A.J. and Lee, W.A., *Principles of the Law of Trusts*, 2nd ed., 1990, The Law Book Co Ltd, Sydney, [14100].

³³⁹ Trustees are civilly liable to restore the trust funds and to make good any loss caused by a breach of trust. Other remedies are –

1. Proceedings to compel the trustee to perform its duty or protect the beneficial interest in the trust property.
2. Proceedings to remove a trustee and appoint a new trustee in its place.
3. An order that trust moneys be paid into court.
4. An injunction restraining a breach of trust.
5. The appointment of a receiver of the trust property.
6. A personal action against a third party who has received trust property. The recipient of the property wrongly distributed may plead that it received the property in good faith and has so altered its position.
7. In certain circumstances, tracing or following the trust property into the hands of the person who received it.

³⁴⁰ 1998 WALRC Report, pp. 52-53 at para [3.15].

“...**[10]** the trust account process will allow the early identification of losses, and **[11]** reduce the potential for project losses to snowball, by reducing the availability of unpaid subcontractor monies to cashflow continued operations. **[12]** In addition this process will require participants to be better capitalised which will benefit the stronger players in the industry.”³⁴¹

In the Inquiry’s view this is a perceptive and correct analysis of the position.

The Reed example again: the imposed discipline of a trust

Mr Melliush was able to further emphasise the same point by means of evidence which in the Inquiry’s view must be given prominence in the report. Mr Melliush concluded that the likely impact of the existence of a statutory trust on the affairs of Reed Constructions Australia Pty Ltd would have been:

*“.....that a Voluntary Administrator would have been appointed much earlier much earlier, possibly 6-9 months earlier. The tipping point for this company was it’s inability to pay wages on time, and without access to funds that would otherwise be quarantined **[13]** for sub-contractors, its own cashflow difficulties would have surfaced earlier likely to have been in December, 2011.*

*An **[14]** earlier VA [voluntary administration] would almost certainly resulted in fewer unsecured creditors (both sub-contractor and other) and many of the existing sub-contractor creditors would have been paid from Trust funds. The impact in a dollar sense is too difficult to estimate, however likely to have been in excess of the total creditors incurred in 2012 which is substantial.”³⁴²*

The Inquiry accepts this evidence without reservation and notes that no contrary view has been expressed.

The capacity of the construction trust to provide an early barometric indicator of the financial conditions in which the head contractor is operating is an invaluable additional benefit.³⁴³ It is another aspect of the way in which the construction trust forces building contractors to be more disciplined and more orderly in the way in which they conduct their business whilst at the same time providing greater transparency.

³⁴¹ John Melliush, Submission of 6 November 2012, p 3.

³⁴² Mr Rollason in his detailed examination of the problem of 23 October, 1996 also pointed out the significance of the early warning role that the trust could provide. He said in much the same way as Mr Melliush, that one of the benefits of the trust is that it provides “early warning signs for failure to pay.”

³⁴³ The early warning signs are needed. In spite of financial checks in the home building industry in NSW through the home warranty insurance scheme, the number of insolvencies in that sector appears to be higher than in any other. This is a disturbing result. It demands a deeper analysis of the current financial qualification procedures.

[15] To the advantages of the construction trust must also be added the additional stability of the subcontracting relationships down the line. The building contractor can be assured that once he has paid the subcontractors then they too are obliged to maintain a separate account through which they pay their sub subcontractors and suppliers.

In this way each participant in the chain is paid what is due and owing to it and the instability and confusion that can result in difficulties at the low end of the scale and reverberate upwards can be avoided.

The taskforce in Alberta, Canada, while investigating similar issues to this Inquiry, in a passage quoted with approval by the Queensland Committee **[16]** concluded that³⁴⁴:

*“This obligation will force the industry to adopt better accounting practices and should in the long run result in fewer business failures.”*³⁴⁵

In advice provided to the National Electrical Contractors Association in October 1996, by Mr John Rollason, an experienced commercial and trust lawyer and a partner in the long established firm of Lane and Lane Solicitors in Sydney, made the valuable point with which the Inquiry is in full agreement **[17]**, that so far as banks are concerned, their security over the project itself is enhanced because the construction trust:

*“...would ensure that funds made available for a project actually went into the project thereby preserving the value of and enhancing the security taken by the financier over the project itself.”*³⁴⁶

The Inquiry spoke with Mr Rollason concerning the events during the time when the trust was being seriously considered. Mr Rollason identified the banks as largely supporting the trust proposal as they could clearly see that their funds were being used efficiently and in accordance with the terms of the loan. Mr Rollason advised the Inquiry that in his opinion, the proposal did not proceed due to effective lobbying by the large contracting companies, exercised through the Australian Banking Association, which claimed that the proposal would have some detrimental effect on the financing of projects and the security available to banks.

³⁴⁴ Each of the numbers in brackets has been added by the Inquiry to the quoted passages.

³⁴⁵ *Security of Payments for Subcontractors in the Building and Construction Industry: Discussion Paper*, November 1991, p. 49 at para 2.25. Reference in extract Alberta Joint Government/Industry Task Force on Builders Liens Report: Builders Liens: Towards Greater Assurance of Payment, 1 December 1989, Alberta Canada, p 15.

³⁴⁶ John Rollason, advice to NECA 23 October 1996, p. 4.

Mr Rollason's analysis of the critical suggestion that disputation would be increased if the trust was introduced, is a compelling one. He made reference to the certification of completion of various stages of the project and said:

“Under the SOPC proposal, this certification [18] would provide the trigger for the passing down of funds. This would tend to resolve or reduce the number of disputes as certification of itself would only arise once a person with power had made a decision that the payment should be paid. If, however, a progress claim were to be made and if the participating party up the chain were to receive payment for the amount contained in the progress claim, the trust structure would prevent that person from withholding payment down of money which he has actually himself under the guise of there being a dispute. It is self-evident that if he has been paid by someone up the chain for a specified item or work, it is not open to him to allege to the person who performed the work for which certification is issued that a dispute can possibly arise. The practice of creating artificial disputes in this matter can be readily obliterated by the existence of the trust obligations.”³⁴⁷

If an insolvency occurs though, the Inquiry is of the view that the statutory construction trust is the only cost effective means by which the consequences of an insolvency may be minimised.³⁴⁸

³⁴⁷ Mr John Rollason.

³⁴⁸ Theoretically, legislation might be introduced to require contractors to take out a payment bond to quarantine payments to subcontractors. The cost? For a project of say \$50m this could cost up to \$750,000 for a rate of 1.5%.

The Context

The Headlines Tell the Story

Subbies stuck in \$17m crash

Latest building firm collapse leaves jobs in limbo

Liquidator reveals Reed Constructions may have been insolvent for months before collapse

Unpaid sub-contractors trigger NSW government reform inquiry into construction industry collapses

Leakage from the project payment cycle

When an examination is carried out on the payment cycle for a particular project³⁴⁹ it can be seen that the head contractor will be faced with a choice as to the treatment of the funds available to it after it has received payment of a progress claim which contains substantial sums of money referable to the work carried out and materials supplied by one or more subcontractors on the project.

Accountants sometimes refer to the situation where a head contractor elects to use the funds from this progress payment for a purpose other than for payment to its subcontractors, as a “leakage” of moneys from the payment cycle of a particular job. That leakage may take a number of forms, each one with its own consequences or possible consequences to the subcontractor.

³⁴⁹ And it is important to bear in mind this is one single project not a picture of complete activities of a single contractor.

Leakage of funds from the project payment cycle may take one and or more of the following forms:

- Payments by the contractor in order to tidy up and complete other jobs (or simply payments for other jobs regardless of the stage at which such jobs have reached);
- The funds may be used to pay off a loan or be absorbed within a bank overdraft in order to reduce the overdraft;
- The funds may be used to purchase personal items such as a holiday home, a boat or for other items of discretionary expenditure;
- The funds may be used to help prop up a development project in which the contractor is engaged on his own behalf.

They are not the kind of payments one would think would win universal approval, having regard to the fact that they are payments made to the head contractor solely because one or more subcontractors have performed the major part of the works and/or supplied materials that are the subject of the progress claim submitted by the head contractor to the owner.

Experience has shown that in cases where leakage from the progress payment cycle has led to the application of funds in any of the four ways described above, there is a significant risk that the head contractor will not be able to get its house in order and regroup so as to make a timely payment of the moneys due or overdue to its subcontractors.

In that event, the task for the Inquiry and ultimately the task for government, is to examine and evaluate the impact of retaining the present freedom of the head contractor to apply the progress payment as it sees fit, against the suggested reforms which act to curtail that freedom. The consideration, which for the Inquiry dominates that examination, is the colourable nature of the contractors “right” to pay away today what it knows has been paid to it yesterday to pay on to the subcontractor tomorrow.

It is suggested that a comparison and an evaluation between the possible applications of the funds would remove from contention any suggestion that there was merit in the head contractor’s use of funds for personal discretionary expenditure outside the progress payment cycle. Similarly, in the case of the head contractor applying funds for the collateral purposes of another development project, there can be no doubt that doing so is fraught with risk which reduces the likelihood that the funds can be re-injected back into the payment cycle for the particular project from which they have been taken.³⁵⁰

³⁵⁰ The Inquiry was told this a number of times.

That leaves the idea that the funds may be used to pay off an existing overdraft or an existing loan. It seems to the Inquiry that if that was the case, there may well be a corresponding diminution in the capacity of the head contractor to reinject the funds back into the payment cycle for the particular project from which they had been taken.

Two other purposes remain to be considered. One being the application of the funds for payment on other jobs and the other being the deposit of the funds into a 'safe' bank account.

As to the use of the funds in other jobs, it seems to the Inquiry that a head contractor who has not been able to satisfy those payments out of its other income earning activities is already exposed to financial imbalances and in those circumstances may have already brought about a reduction in the likelihood that the funds would be reapplied to the payment cycle from which they have been leaked.

That brings the Inquiry to an analysis of what happens in fact in many of the large contracting organisations when progress payments from an owner are washed into the head contractor's bank account. The Inquiry has examined a series of contentions made in relation to such funds by Mr Brian Silvia, Principal BRI Ferrier, a business reconstruction and insolvency practice. Mr Silvia raised important considerations arising from the relationship between the banks and large contractors which are generated by those circumstances set out in an upcoming section of this Report.

Two sides of the same coin?

Listening to the evidence of many witnesses with long experience in the industry, there are two schools of thought on the use of funds during the payment cycle.

The first school of thought rests on the proposition that payment is not yet due and payable to the subcontractor and so, for that reason alone, it is said that the head contractor can do what it likes with the moneys, so long as it pays the subcontractor in accordance with the subcontractor's payment terms.³⁵¹ This is of course what happens when the more successful, better run head contractor companies are operating in the 'good times'. It says nothing about those who are at the margins and "robbing Peter to pay Paul".

At the opposite end of the spectrum, the second school of thought propounds that the builder is not entitled to treat the moneys as his own even though the time for payment to the subcontractor has not yet arrived.

³⁵¹ Thereby hangs a tale.

A third consideration?

In the view of the Inquiry, while in theory in that time leading up to crystallisation of the head contractor's obligation to pay its subcontractors, it is legally free to 'juggle' the money, nevertheless the head contractor is honour bound *not to do anything that will prejudice its ability to pass on the money earned by the subcontractor which in effect has been paid to the head contractor by the principal.*

The examples outlined above do not exhaust the full range of possibilities of use of moneys during the payment cycle and it must be remembered that the progress payment by the owner to the head contractor is in the first instance paid into a bank account. That simple deposit into a bank account owned and administered by the head contractor is an act of legal significance in relation to the payment of money. The money is money to which the head contractor is entitled and it is also entitled to say that it can make such use of it as it sees fit so long as it pays the subcontractor on time. The law supports this analysis insofar as it makes clear that the moneys paid into the head contractor's current bank account at that stage are not trust moneys. There is no other legal alternative: the moneys are either moneys to which the head contractor is entitled or they are not.

What this analysis overlooks is that the freedom offered to the head contractor under the present law to deal with the owner's progress payment in one or another of the alternative ways listed previously, may have important consequences to the subcontractor. Any leakage of funds comprised in a progress payment of that kind, outside the project payment cycle, has the potential to cause loss to the subcontractor. A choice must therefore be made whether or not the head contractor's freedom to use those funds in whatever way it thinks fit should be curtailed and that choice involves a selection between alternatives, each of which has been analysed and evaluated with a view to determining where the balance lies.

The so-called "cash flow" requirement: but whose cash?

In the event that the moneys are to be deposited into a bank account in any event, the Inquiry focussed upon the use in fact made of those funds from that point onwards by the head contractor.

A number of requests were made of head contractors suggesting they might like to provide such information to the Inquiry. Whilst what the Inquiry was able to learn about that subject did not cover the whole of the large contractors in the building and construction industry in NSW, there was nevertheless a sufficient response to the Inquiry's questions to enable the Inquiry to form a view as to the use being made of those funds and to gain some idea of the amount of income earned by the head contractor from the investment of those funds during the payment cycle.

At this point in the analysis the Inquiry reminds itself and respectfully suggests that the readers of this Report including those in Government to whom it is intended, should bear in mind the conclusions of the thorough 1991 Queensland Discussion Paper.

In the conclusions of that 1991 Queensland Discussion Paper, the sobering comment was made that:

*“The building industry has become infamous for its non-payment of subcontractors. Unlike other industries which have an employment tradition, the building industry escapes the mechanisms which protect the work forces of other commercial and industrial enterprises”.*³⁵²

The 1991 Queensland Discussion Paper went on to say:

*“The non-payment of subcontractors has created a virtual black hole of subcontractor losses: over \$50 million since January this year claim to have been quantified.....It is not a matter which builders can, or are prepared to address. Default due to insolvency is only half the problem, according to subcontractor organisations. They report habitual non-payment of final progress payment and retention. The matter is lent extra urgency by the increasing practice of builders requiring upfront performance bonds (often demanded in cash) of subcontractors.”*³⁵³

The evidence before the Inquiry demonstrates that examples of such sentiments may be multiplied and it is quite simply time for such accurate complaints of that kind to be remedied by Government. There have been numerous reports which have clearly outlined what are agreed on all hands to be effective legal mechanisms to overcome this problem.

With those thoughts in mind it is appropriate to return to the analysis of the position in which the owner has paid a progress claim to a head contractor which involves payment for quite substantial work carried out and material supplied by one or more subcontractors.

If that money remains in the bank account into which it is originally placed then that is a good start. However a moment's reflection demonstrates that the money is still not safe. It can be attached by the head contractor's bankers depending upon what are the terms and conditions of the bank's lending and credit facilities.

³⁵²1991 Queensland Government Discussion Paper, p. 73 at para 1.1.

³⁵³ Ibid, p. 73 at paras 1.2 and 1.3, Reference in extract to Kim Sweetman's article, "Subbies lose when builders fail: lawyer", Courier Mail, 13/9/91, citing Condi Francesco – Brisbane.

The Focus

In the view of the Inquiry the most important aspect of this recommendation is the requirement that the Inquiry investigate and place before the government the evidence it has gathered concerning the use to which head contractors put the progress payments they have obtained from owners during the period leading up to the payment of subcontractors' progress payments.

It is curious that this has not been at the forefront of submissions received by the Inquiry from the contracting sector of the industry. It has therefore been necessary for the Inquiry to take the initiative, in many interviews of witnesses and correspondence, in surveys and in the distribution of the detailed Inquiry Discussion and Issues Paper 2012. The questions upon which this section of the Report have been based are set out on pages 42-43 of the Paper as follows.

Questions/Issues for comment

The Inquiry wishes to be in a position to advise the Government of:

- g) The approximate amount of such funds being invested from time to time during the payment cycle so that the Government may make a clear and helpful appreciation of the effect upon the conduct of business in NSW if there was to be a restriction which clamped the ability of the contractors to use funds in that way.
- h) The nature of such investments and in particular how secure they are.
- i) The terms of such investments whether they are at call or otherwise and so on.
- j) The range of rates of return upon such investments.
- k) How the investments are treated in the accounts of the head contractor.
- l) How important to the financial position of head contractors is the income that is earned from these investments.

Contractors and other interested parties to whom this Paper has been sent are invited:

- 1) To respond to those matters about which the Inquiry seeks further information in relation to the contractor's use of free capital.
- 2) To comment and critique the commentary in this section and in particular, any issues concerning the payment cycle case example and model provided.
- 3) To prepare and forward their own model of the investment/payment cycle.

After an address by the Chair to an industry gathering on 11 October 2012, which included representatives from across the significantly different sectors of the building

and construction industry, the Inquiry received a helpful written submission from Mr Brian Silvia, from BRI Ferrier. Mr Silvia's observations concerning the possible effects of the statutory construction trust are worthy of close analysis. Mr Silvia has said that;

“The introduction of a trust concept will (unless in some way progressively moderated as to its introduction) represent a major impact on banking facilities currently enjoyed by builders. The work in progress element of a builder's balance sheet more often than not is pledged in favour of a bank supporting an overdraft facility under a debenture charge. The Bank in addition may have granted Performance Bonds. Extraction of work in progress from the balance sheet describing it as a ‘trust asset’ will destroy most building company loan value ratio arrangements with their bankers.”³⁵⁴

Mr Silvia went on to say;

“The creation of a trust attaching to progress claims will:

- *Ensure progressive claims in a normal business environment being paid to sub-contractors etc. on a timely basis.*
- *Will not however ensure that any monies flow to sub-contractors in the event of an insolvency. Typically in an insolvency, issues will have arisen as to the performance of individual contracts where invariably there is no progress draw entitlement in favour of the builder and consequently no monies available for distribution to sub-contractors.”³⁵⁵*

The advice received from Mr Silvia has been the subject of further consideration by the Inquiry. Banking practice has it that moneys owed to subcontractors are taken into account in a rather curious way, that is to say that the bank theoretically seems to acknowledge that the moneys once in the contractors account are available for “scooping”³⁵⁶ by the bank. However the matter is not as simple as that. The banks recognise that the funds are not the fully unencumbered property of the head contractor in the sense that when looking at the matter from the view point of a balance sheet, the bank takes into account that its customer has a corresponding liability to pay the moneys out to the subcontractor. Without intending to reflect adversely upon banks it seems to the Inquiry that there is a significant element of opportunism about the way in which progress payments to a building contractor are approached. Knowing that the contractor is contractually obliged to pay those moneys on almost immediately the bank nevertheless casts a wary eye upon any funds which happen to pass through its

³⁵⁴ Brian Silvia, BRI Ferrier Letter dated 16 October 2012, p.1.

³⁵⁵ Ibid, pp. 1-2.

³⁵⁶ Scooping is an expression common in North America describing what happens when a bank attaches any money that happens to be in the account of the debtor.

customer's account. Whatever approach the banks take to such funds the bank does not regard the customer as being entitled to those funds in a full and unqualified sense.

The Inquiry has also received evidence that banking practices are unlikely to change in the event that there was a statutory trust imposed to deal with the receipt of progress payment claims by building contractors which contain substantial amounts of money destined to be paid on to the subcontractors.

The Inquiry's response

It is essential that the Inquiry seek to come to grips with these issues. Firstly what is to be "extracted" from the balance sheet of the contracting company will not be any of the moneys owed to the contracting company itself. What will be ring fenced are those moneys that are owing to the subcontractor. The 'works in progress' component is the result of work carried out by the subcontractors – that is 80% of the total work in progress. Secondly, what Mr Silvia is referring to here is the situation where there is a dispute as to whether moneys are due and payable. This position is not brought about by the trust. However, it is not a problem as any dispute will be decided by SOPA and moneys will become available for distribution to subcontractors as a result of the SOPA adjudication.

The Inquiry has accepted the views of Mr Silvia and others from the industry that the recommendations of the Inquiry if accepted, should be transitioned over a two year period.

The SOPA procedure

SOPA was introduced for good and sound reasons however it is as plain as can be, that it is not enough to protect subcontractors because:

- Many subcontractors are not willing to use the procedure. In the summary findings section of this Report, the full range of issues that have been put to the Inquiry as to why many subcontractors are reluctant or unwilling to use SOPA are set out. In summary though, the most frequently stated reasons are: that the procedures are too complicated and technical; that the costs of a simple adjudication claim can be thousands of dollars; and that in the event of insolvency of the head contractor, any adjudicated amount 'awarded' may never be paid.
- What is needed is a remodelled landscape in which Parliament enacts sanctions which would militate against the necessity of subcontractors having to make odious choices which in their view, justifiably, might result in them being sent to

purgatory by contractors who do not relish being drawn into the adjudication process.

- The adjudication process costs money which the subcontractors can ill afford. On an extremely rough and ready basis for example an adjudication involving a subcontractor's claim for \$65,000 might involve \$3,500 in costs.
- If the contractor is insolvent then SOPA is of no value whatsoever.
- SOPA was never intended to be a remedial provision in insolvency. Its purpose and intent was to ensure that money flowed down the line as quickly as possible and that subcontractors were not kept out of their money without justification – the aphorism “pay now argue later” is both apt and accurate. The Inquiry has attempted to align its recommendations with SOPA.

Nothing has changed except further convincing proof of the need for reform

The reasons for the Inquiry's recommendation concerning the construction trust and indeed the reasons that led to the introduction of SOPA back in 1999, are the same reasons which have provided the impetus for the establishment of this Inquiry.

The Inquiry has observed that over the years there have been cyclical or seasonal and certainly not unexpected contractor insolvencies which continue to throw up the same questions time and time over. The reasons are the same today as they were years ago.

The recent collapse on 24 October 2012 of Southern Cross Constructions (NSW) Pty Ltd and Procorp Group of Companies which includes the residential home builder Holmwood on 13 November 2012, has rammed home not only the justification for the establishment of the Inquiry but in the Inquiry's view, a demonstrated need for the implementation of the recommendations set out in this Report.

Western Australia

The detailed, reasoned Report of the Law Reform Commission of Western Australia (“1998 WALRC Report”), remains one of the most scholarly and convincing analyses of the statutory construction trust. It is essential reading. The relevant sections of the 1998 WALRC Report are set out in the Appendix to this section of this Report.

The fate of the 1998 WALRC Report's recommendations

The Inquiry understands that the recommendations of the 1998 WALRC Report relating to the adoption of the trust proposal were not adopted at least in large part due to the reliance on Crown Solicitor's Office advice. After several attempts, the Inquiry has been unable to obtain a copy of this advice and is unable to determine whether any opposition to the trust option in that advice, relied on the same or similar arguments put up elsewhere in other reports. Readers of this Report should be left in no doubt as to the Inquiry's view of the scant evidence and flawed assumptions on which past opposition to the trust has typically been based upon.

One may also assume that there was a strong contractor lobby against the introduction of the trust, although the Inquiry has no direct evidence that that was the case.

The Inquiry respectfully agrees with the analysis and reasoning of the 1998 WALRC Report.

Queensland

The Queensland Model

After a root and branch review, there was introduced into Queensland major structural reform worthy to serve as a model in relation to the financial requirements of industry participants, for the other Australian States and Territories.³⁵⁷ The Inquiry's reasons for holding this view are set out below.

In particular the Queensland model ensures that so far as it can be legislated for, contractors:

- come into the industry and remain in an apparently healthy state;
- are required to back their project ambitions with a sliding scale of capital backing;
- pay contractors promptly; and
- subject themselves to the conduct of statutory audits.

In 2011/12, the BSA:

".....conducted 963 audits of licensees suspected of exceeding their financial capacity to ensure their financial viability."³⁵⁸

³⁵⁷ Same for the non-inclusion in the Act of the construction trust.

³⁵⁸ Queensland Building Services Authority Annual Report 2011/12, p 23.

In that same year the BSA excluded 311 individuals and 99 companies from holding a license for five years due to their involvement in a financial failure. These figures represent an increase from the previous year.

A strong case can be mounted for the adoption of the essential elements of the Queensland legislation. The Inquiry's analysis of that question appears elsewhere in this Report.

The absence of the construction trust in the Queensland model almost certainly reflects a preference for the *preventative* measures requiring capital backing commensurate with project values. This approach receives powerful support from the auditing provisions in the Queensland Act.

Criticism of the construction trust system

It should be the necessary function of any Inquiry such as this to ensure that those views which may be thought to stand in opposition to the recommendations of the Inquiry, should be set out in detail in a convenient and readily referable way so that a balanced view of the issues may be expressed and presented for analysis by Government decision makers and interested parties alike.

A fair and balanced report to Government should include in detail, reference to the previous criticisms that have been made of the construction trust proposal. The Inquiry will in the following section of this Report analyse the criticisms which have been made of the statutory construction trust with a view to enabling Government to assess those criticisms in the light of the Inquiry's responses to them.

The material to be examined in that way includes the following:

1. The Andersen Consulting Report, 28 May 1993.
2. The Queensland Government Discussion Paper, November 1991.
3. The Construction Industry Development Agency (CIDA) Final Report, June 1994.
4. The Price Waterhouse Report, July 1996.
5. The Coopers & Lybrand Report, August 1996
6. The 1998 Legal Commentary.
7. NSW Crown Solicitor's Office Advice, 1 April 1998.
8. The Western Australian Taskforce Report, November 2001.
9. The Queensland Building Services Authority Discussion Paper, December 2001.

10. A report prepared by the Joint Standing Committee Upon Small Business entitled “Security and payment, deemed trust: the full debate” dated 19 August 1998.
11. A commentary prepared by Mssrs Denis Armstrong (Chair), Geoffrey Jochelson and John Rollason for the NSW Security of Payment Committee entitled “The Andersen Report is Wrong” dated 21 May 1994 (the Armstrong Report)

The latter two reports answer many of the questions raised by the earlier reports.

A table of reports and discussion papers that have included recommendations, analysis or comment on the trust approach, has been included in the appendices section of this Report.

The Inquiry will turn first of all to the Andersen Report and examine its discussion of the statutory trust account. The Andersen Report contains a number of unsupported generalisations which have simply been repeated without analysis, in later reports. It is therefore useful to deal firstly with the Andersen Report.

The Andersen Report

The Andersen Report when properly analysed, is a nonanalytic document which simply threw up a series of questions without answering those questions in a closely reasoned way or at all. In a sense though, the Andersen Report is useful simply because it has posed those questions even though it did not seek to answer them itself.³⁵⁹

Nevertheless the Andersen Report has stood as a kind of gloomy Cassandra³⁶⁰ predicting the doom of the construction trust without subjecting it to a proper analysis. Although unlike Cassandra, its predictions are unlikely to eventuate.

Whilst irretrievably flawed, in one important sense, the Andersen Report is to be commended because what it has done in essence is to remind the Inquiry that the statutory construction trust raises a number of questions and that if the Inquiry is to do its work, it should answer those questions.

When properly examined and tested in the way the Inquiry’s responses have in the large number of meetings held with interested parties, the Inquiry has firmly concluded that

³⁵⁹ Andersen Consulting no longer exists. See for example Leonhardt, D., “*Andersen Split Into Two Firms by Arbitration*”, 8 August 2000, The New York Times.

³⁶⁰ A beautiful Trojan princess, daughter of Priam and Hecuba, whom Apollo endowed with the gift of prophecy.

the Andersen Report is not a legitimate obstacle to the implementation of the trust. At best it throws a number of questions up into the air, declines to attempt to answer those questions and then simply says it is all too hard and the proposal should not be carried any further.

That is not a rational or sensible approach to the question of law reform in the face of overwhelming evidence crying out for remedial action.

Perhaps the most compelling reason for placing the Andersen Report in its small niche in the passage of events is that it preceded the introduction of SOPA. It is a close run thing but in the view of the Inquiry it is not simply that the Andersen Report pre-dated SOPA that confers an archaic classification upon the Report, it is the fact that in the face of numerous inquiries before, after and during the preparation of the Andersen Report, it can confidently be concluded upon the basis of overwhelming evidence, that there were serious payment problems in the industry and yet the Andersen Report preceded on the basis that there were not.

The nature of the proposal examined by the Andersen Report

The proposal under examination by the author of that report provided that all moneys received by each party in the contractual chain are to be held in a deemed trust in order for the supplier of goods and services to that party to be paid.

In the case of the owner, payment was to occur within seven days of certification that those moneys are due and within seven days of receipt of payment from the party above in all other cases.

The trust proposal also embraced funds advanced under mortgage or other security to or on behalf of the owner and included any funds in the hands of the owner or recovered by the owner for payment of any improvements. Also covered were any funds or source of funds identified by the owner, as funds for paying the cost of the improvement and any revenue generated from the improvements subject to prior encumbrances. The proposal also embraced any funds derived from the sale of the improvement subject to normal expenses and encumbrances together with the net proceeds for insurance should the improvement be damaged or destroyed.

The Inquiry's response

The first important point to bear in mind is that those proposals are in many respects the amalgamation of the three different trusts which are set up by Sections 7, 8 and 9 of the Ontario Act.

In contrast, the proposals recommended by this Inquiry do not involve bringing the owner into the trust arrangement, nor do they involve drawing into any of the trust accounts the additional sources of funds referred to above.

Of the three kinds of trusts in play in Ontario this Inquiry is recommending only the middle trust - the 'contractor's and the subcontractors trust' which involves money received by the head contractor and the subcontractors.

That quite different proposal which is much more limited than those under consideration in the Andersen Report, means that many of the criticisms in the Andersen Report are of no relevance.

The Andersen Report must be approached with some care and with the resulting reservation that it proceeded upon the basis that:

“Current information, however, suggests that security of payment is less than a problem than might be thought. While the current data is insufficient to arrive at an unequivocal finding the available information does warrant the following conclusions:

- *payment default and late payment do not appear to the extent indicated by anecdotal evidence;*
- *there may not be a domino effect from the failure of contractor;*
- *there is mixed information regarding the relevant incidence of failure between building companies and companies in other segments; and*
- *NSW builders fail for reasons which do not appear to be unique to the building industry.”³⁶¹*

In the Inquiry's view the answer to each of those criticisms lies in the abundance of evidence to the contrary before this and numerous other inquiries, committees and Royal Commissions.

The detailed findings of the Cole Royal Commission and the findings of this Inquiry which are in keeping with those findings, involve the rejection of the propositions upon which the whole of the Andersen Report seems to have been based. Each of the initial propositions of the Andersen Report is, in the opinion of the Inquiry, unsound and should not be preferred to the instinct and judgement of Government which led to the establishment of this Inquiry. If any of the quoted passages of the Andersen Report were right, then the establishment and work of this Inquiry was a waste of time. That has been far from the case.

³⁶¹ Andersen Report, p. 7.

There is another reason why any support for the conclusions of the Andersen Report should be disregarded. In 1993 it may well have been the case that “*subcontractors are doing quite well*”³⁶², a piece of evidence which was considered to be of some importance by the Andersen Report.

Other passages in the Andersen Report which minimise, downplay or trivialise the crunching consequences of non-payment or insolvency in the industry also suggest that the report is out-dated and out of line with what is currently occurring in the industry.

The major problems and legal issues with the trust proposal

After concluding that:

*“there is no evidence that in the short term sub-contractors would reduce prices as a result of their reduced overheads, improved cash flows.....”*³⁶³

the Andersen Report went on to examine what it called “the legal issues”. It drew the conclusion that:

“Legally, too, the proposal has some serious flaws. There are major problems with third parties, trust assets, disputation procedures and the Federal Constitution. Additional difficulties arise with other lesser consequences of the Proposal and some administrative burdens”.³⁶⁴

This was a less than an auspicious beginning for the construction trust. Each of these unsound criticisms will be addressed in turn.

“Third parties brought into disputes”

The Andersen Report stated:

“One of the most serious consequences of the Proposal is that third parties may be dragged into disputes and suffer consequential loss. This is because a trust transforms the normal contractual financial arrangement of debtor and creditor into a fiduciary arrangement. Third parties could be affected if they met two key criteria:

- *If they have received trust funds without consideration (i.e. goods or services), and/or*

³⁶² Ibid. p. 11.

³⁶³ Ibid. p. 17.

³⁶⁴ Ibid. p. 21.

- *If they have provided consideration and have some imputed or prior knowledge of the source of the funds. Imputation may occur simply as a result of the Proposal being legislated. There may also be an additional burden placed upon third parties when contracting with trustees to confirm that any payments are free from potential fund tracing action by other parties.*”³⁶⁵

The Inquiry's response

This is a disappointing criticism and one that is entirely beside the point. The only way that a third party can be “dragged into disputes and suffer consequential financial loss” is if that party falls within the rule in *Barnes v Addy*, a rule formulated in 1874.³⁶⁶

Third parties will only be liable where they have wrongfully and with knowledge of the trust, assisted a wrongdoer in the dispersal of trust funds. It can hardly be logged as a criticism of the construction trust fund proposal to say that it drags a third party into a dispute, when in reality the third party will only become liable by reason of its wrongful breach of a principle which has stood for the last 130 years and has been fully affirmed in the High Court of Australia as recently as 2007 in *Farah Constructions Pty Ltd v Say-Dee Pty Ltd*, [2007] HCA 22.

Indeed, in an article entitled “A Canadian Approach to the Minimisation of Construction Insolvencies”, Reynolds states the point in this way:

“There are three fundamental questions to be asked in determining whether a contractor’s bank has violated the trust provisions found in the applicable line legislation. These three questions are:

- *Whether the funds deposited by the contractor are subject to a statutory trust;*
- *Whether the bank knew or ought to have known of the statutory trust; and*
- *Whether the bank knew or ought to have known of the breach of trust and participated therein.*”³⁶⁷

It is necessary that all three questions be answered in the affirmative in order for a trust claimant to succeed in a claim against the contractor’s bank for breach of trust.

³⁶⁵ *Ibid.* p. 21.

³⁶⁶ (1873-74) LR 9 Ch App 244.

³⁶⁷ Reynolds, B., “A Canadian Approach to the Minimisation of Construction Insolvencies”, ch. 5 in Davis R. and Odams, M. (eds), *Contemporary Issues in Construction Law*, vol.1, Security for Payment, 1996, Construction Law Press, Centre of Construction Law & Management, King’s College, London, pp. 117-162 at 130.

The second reason for rejecting the Andersen Report criticism, is that one of the reasons why the trust concept is advocated is *because* it provides an additional protection to the subcontractor in the precise event of unlawful dispersal of the trust funds by third parties. Far from this being a disadvantage which is said to be “potentially *“the most difficult” aspect of the present SAPC proposal...*”³⁶⁸, the involvement of third parties is a powerful additional safeguard to the subcontractor. The flavour of the Andersen Report shows the writer striving by use of exaggeration and misattribution, to dredge up any possible criticism with a view to justifying the headline *“The Proposal has some serious flaws.”*³⁶⁹The report tries too hard and falls well short.

“Trust Assets”

The Andersen Report states that:

“Trust assets

- *There could be difficulties with the identification of the funds which constitute the trust (there is then a footnote reference to Appendix C for a more detailed explanation). This would lead to increased disputation and compromise the very basis of the trust.*
- *There is a suggestion that trustees can use trust funds for their own purposes. This again runs contrary to one of the principles of trust law.*³⁷⁰

The Inquiry’s response

Once again this is a disappointing misstatement of both the effects of the trust and the proposed law. The language is sweeping, unrestrained and general. The answer to the first proposition is that there is in fact no difficulty with the identification of the funds which constitute the trust. The answer to that question is provided by the terms of the statute which creates the trust. The trust funds are any moneys paid by the owner to the head contractor in respect of work carried out by the subcontractors.³⁷¹

As to the claim that it will lead to increased disputation, nobody has ever contended that the trust proposal will solve difficult questions raised by the existence of disputes in the building and construction sector. Those disputes have been going on for hundreds of years regrettably, and they have proven to be in large measure, intractable. But that is where SOPA comes in. This legislation came into effect after the Andersen Report and in this respect renders a significant amount of the assertions in the

³⁶⁸ Ibid. p. 21.

³⁶⁹ Ibid. p. 21.

³⁷⁰ Ibid. p. 21.

³⁷¹ For example see the Maryland trust example in an earlier part of this section.

Andersen Report outmoded and irrelevant. However, it is still important for the Inquiry to deal with the suggestion made in the Andersen Report.

Another example

Take the example of a progress claim made by the head contractor against the owner for say \$2 million and assume that the owner disputes its liability to pay that amount. The head contractor will then have remedies under SOPA. The use of SOPA will result in a rapid determination of an interim adjudication setting out exactly what is then due and payable by the owner to the head contractor. When that amount so determined is paid into the head contractor's trust account that amount will be impressed with the trust.

It is true that one or both of the parties to that interim adjudication may not be happy with the result. In that event, once the project has been completed either one or other of those dissatisfied parties may go to court, commence arbitration proceedings or if the adjudication alternative dispute resolution clause in the contract between the parties involves an expert determination, avail itself of that method. If the claimant in the SOPA application is found not to be entitled to any of its claim then nothing will go into the trust.³⁷²

It is not to the point to criticise the trust proposal by referring to long held dissatisfaction with difficulties of resolving engineering and construction disputes which have nothing to do with the trust proposal itself and were not intended and nor could they be addressed by the trust proposal.

What the Inquiry seeks to do with the recommendation concerning the construction trust is to dovetail it with the provisions of SOPA.

The Inquiry rejects the notion asserted in the Andersen Report that:

“There could be difficulties with the identification of the funds.....This would lead to increased disputation and compromise the very basis of the trust.”³⁷³

As to the reference to “... a suggestion that trustees can use trust funds for their own purposes. This again runs contrary to one of the principles of trust law.”³⁷⁴ It is quite correct as a general statement and is best placed to one side by saying that it simply does not apply to the trust which is being recommended by the Inquiry. Further, a

³⁷² The statutory trust will continue to apply to any money recovered after the conclusion of the project, which might be recovered in court or arbitration proceedings commenced by a party disappointed with the SOPA outcome.

³⁷³ *Ibid.* p. 21.

³⁷⁴ *Ibid.* p. 21.

specific recommendation by the Inquiry ensures that the trustee/head contractor's rights to invest progress payments, which have been deemed to be trust funds, will be preserved up to the point at which those moneys become due and payable to the subcontractor.

Under the Inquiry's proposed model there is no possibility of trustees lawfully using trust funds for their own purposes any more than would apply to any other trust established by any other means. Moreover, the Inquiry in its recommendations has included machinery provisions for insuring that so far as possible, that does not occur.

The Andersen Report, not for the first time, has mistakenly referred to a particular matter as giving rise to a criticism of the trust which when properly understood, the so called criticism is one of the strengths of the trust. The Inquiry refers again to the advantages to be gained by segregating and properly labelling the trust fund as a trust fund, and extending the area of recovery available to the subcontractor against those who have in any relevant aspect been implicated in the breach of trust.

“Disputes – frozen funds”

Once again there is evidence in the Andersen analysis of exaggeration and misstatement of the relevant legal principles. It has been said above that the Andersen Report pre-dated the introduction of SOPA. The importance of that statement may be underlined when one examines what is said under the heading:

“Disputes – frozen funds:

- *If a dispute arises after certification it is likely that all the funds held in a trust will be frozen for the duration of the dispute.*
- *In the instance of a dispute between a head contractor and a sub-contractor this will affect the funds of all sub-contractors and the head contractor.*
- *If funds are, however, not available (or do not exist) for payment of creditors then, by definition, they cannot be deemed to be in trust, and cannot be paid out.*³⁷⁵

The Inquiry's response

These propositions are without foundation. If there is a dispute after certification much of course depends on the nature of the certificate. In some contracts the issue of a certificate requires that the moneys be paid and the dispute resolution mechanism in the contract will then kick in. However under SOPA, if a dispute arises at any time it will be resolved on an interim basis in accordance with the procedures established by that Act. In any event whether or not that is a dispute about part of the funds in the trust

³⁷⁵ *ibid.* p. 21.

account, can simply never give rise to a situation in which “*all the funds held in a trust will be frozen for the duration of the dispute.*”³⁷⁶ That unrestrained contention has no support in law and cannot occur in the present case for the following reasons:

- i) If there is a dispute it will be resolved by SOPA and the money will be paid on an interim basis to the successful party in the adjudication.
- ii) If that party is the head contractor then the moneys will be paid by the owner and will go into the trust account and be immediately disbursed from the trust account to those subcontractors who are entitled to be paid.
- iii) If there is insufficient money in the trust account to pay all of the subcontractors then they will still have their rights in contract in any event.
- iv) The trust fund can never be totally frozen whilst there are moneys in the fund that are legitimately owing to one or more of the subcontractors; they must be paid out.
- v) That position is reinforced by the statutory obligation recommended by the Inquiry to pay head contractors and subcontractors within 15 and 28 days respectively.
- vi) If in the event that there is a dispute and the dispute is resolved in the first instance by the SOPA provisions, then both parties may elect at the end of the contract to maintain their disputation, or to settle on the amount adjudicated or some other agreed amount.
- vii) The trust cannot of itself instantly resolve a dispute. That is what the Parliament introduced SOPA to do on a speedy interim basis. Nor does the trust give rise to or generate any other kind of dispute about entitlement under the relevant construction contract that would not have been generated in any event.

The contention is without foundation except in one unlikely set of events.

Then the last criticism is said to be relating to funds not being available for payment of creditors. It is said somehow to be a criticism of the trust that such funds “cannot be deemed to be in trust, and cannot be paid out.”³⁷⁷ That rather prosaic statement of the obvious is hardly a critical reflection upon the trust. The trust will only come into existence so far as moneys are made available by an owner. No proponent of the trust has ever held out that it has the capacity to magically enhance the financial reserves of an impecunious or straightened owner.

“Federal Constitution”

The author of the Andersen Report then goes on to say that:

³⁷⁶ Andersen Report, p. 21.

³⁷⁷ Andersen Report, p. 21.

“The effect of the proposal may be limited if it is not enacted in all Australian jurisdictions. There may be an incentive for those further up the trust chain to exempt themselves from the process by moving their place of residence out of NSW.

If there were an attempt in the Proposal to address this situation by legislation to maintain banking accounts in New South Wales, or some other measure to ensure compliance with the Proposal, there could be a challenge as to the legislation’s validity under Section 92 of the Constitution.”³⁷⁸

The Inquiry’s response

In the Inquiry’s response to this criticism, it is difficult to do better than to repeat the analysis of the 1998 WALRC Report completed in 1998 by WS Martin QC, now Chief Justice of Western Australia.

Chief Justice Martin addressed the concern by reference to the same words used in the Andersen Report.

The 1998 WALRC Report said:

“However, the state parliament can enact laws having extra territorial operation.”³⁷⁹

When referring to the extra territorial operation of state laws the WALRC Report referred to the relevant test for the validity of laws:

“which affect persons, conduct or things outside the state, so long as the law has a sufficient connection with the state.”³⁸⁰

As to the concern which the Inquiry assumes to have been genuinely expressed although somewhat obliquely, that the trust scheme would breach section 92 of the Commonwealth Constitution which provides that “.....trade, commerce, and intercourse among the states... shall be absolutely free”, the WALRC Report firmly rejected that proposition because in its words, with which the Inquiry respectfully agrees:

³⁷⁸ Andersen Report, p21-22.

³⁷⁹ *Australia Act 1986* (Cth) s 2(1). This may be contrasted with the position in Canada where it seems that provincial statutes do not have extra territorial operation: *Horsman Bros Holdings Limited v Sigurdson* (1979) 104DLR (3d) 458, 462.

*“...a trust scheme would not impose Government controls or burdens which discriminate against interstate trade and commerce so as to protect intrastate trade against competition. Nor are government controls to resolve problems, which are not designed to protect intrastate trade against interstate competition invalid if they are ... appropriate and adapted to the resolution of those problem [and if] any burden imposed on interstate trade was incidental and disproportionate to their achievement”.*³⁸¹ (see *Castlemaine Tooheys Ltd v South Australia* (1990) 169 CLR 436 at 473 and *Cole V Whitfield* (1988) 165 CLR 360.)

It is regrettable that in an attempt to discredit the trust concept, that the writer did not trouble to examine any of the High Court jurisprudence on the subject. Needless to say, if the spectre of s. 92 hung over the trust account there are many statutory trust account provisions for travel agents, real estate agents, solicitors and so on, which would be, but have not been affected.

The writer of the Andersen Report then goes on to say that there are at least seven other major consequences which would arise from the proposal. Each criticism is set out below together with the Inquiry’s response:

“Difficulty for Head Contractors to Obtain Finance”

The Andersen Report then stated:

*“Financiers will be more at risk because their interest will, in some circumstances, rank behind the beneficiaries of the trust. This could have the effect of increasing the financing costs for head contractors. This is quite apart from financing difficulties which may be experienced by head contractors because of increased costs of project funding generated due to changes in the cash flow cycle.”*³⁸²

The Inquiry’s response

There was no evidence to the Inquiry from a financier to this effect.

QBE Insurance, the leading bond and surety financier, disagreed with the contention.

³⁸¹ WALRC Report, p. 55 para 3.20.

³⁸² Andersen Report, p. 27.

As Mr John Rollason stated in his advice of 23 October 1996, payment of subcontractors is likely to preserve “.... *the value of and enhancing the security taken by the financier over the project itself.*”³⁸³

Problems of that nature were not raised by the Australian Bankers Association after consideration of the Inquiry’s Discussion and Issues Paper 2012.³⁸⁴

In the view of the Inquiry, a contractor’s financial position can hardly have gotten worse by reason of it promptly paying its creditors.

“Increased litigation”

The Andersen Report then stated:

*“The Proposal could make litigation a more attractive option for subcontractors who would seek to exercise their rights under the proposed scheme. There may also be an increase in the number of claims because there would be more people from whom to extract monies (i.e. the officers of the trustee based upon their fiduciary responsibility). The potential involvement of third parties, referred to previously, also increases the likely incidence of disputation.”*³⁸⁵

The Inquiry’s response

This criticism of the proposal is purely speculative. It must be accepted however that any law reform must lead to some litigation.

Any claim made in whatever forum by a subcontractor is only as good as the inherent quality of the claim itself and the extent to which it can be said to rest in contract or to rest upon any other established legal basis. The existence of a trust fund against which to make a claim will not result in any further litigation than would have been the case anyway. In order to establish an entitlement to the money in the trust fund, a subcontractor would have to have established precisely the same things that it would seek to establish either in an adjudication under SOPA, in court proceedings, in arbitration proceedings or any expert determination process. The only additional right given to the subcontractor is to enforce its proven claim against a preserved fund which has been held upon trust, rather than have to run the risk of pursuing an insolvent trustee/head contractor. Once moneys have been paid into a trust fund it is already established that the subcontractor is entitled to at least some of an agreed part of those funds. The funds must then be paid out immediately and if not done so within 28 days,

³⁸³ John Rollason, Advice to NECA 23/10/96, p. 4.

³⁸⁴ ABA submission dated 15/11/12.

³⁸⁵ Andersen Report, p 22.

the trustee/head contractor will be in breach of the law and the subcontractor will be entitled to penalty interest.

If there is a dispute it must be resolved through SOPA.

That is well and good, however the conclusive answer is that moneys paid into the trust fund are those to which the subcontractor has been earlier judged entitled either by the certification or agreement of the head contractor who has passed them up the chain. If once the funds are in the trust account, if there is a dispute as to the amount paid out to the subcontractor, then SOPA will determine that dispute.

The old claim that “...*the potential involvement of third parties will increase the likely incidence of disputation*”³⁸⁶, has been referred to previously. This is no doubt, a reference to the rights given to any beneficiary to bring proceedings against a third party who knowingly or with constructive notice assists a wrongdoer in a breach of trust. It can hardly be lamented that that is likely to increase disputation.

Indeed, the only occasion it would be necessary to rely upon that particular right would be when, as has been said above, a third party in the position of a bank, for example, has acted wrongfully. The Inquiry is not able to discern anything undesirable about a wrongful participator or one who assists in a breach of trust being held liable in accordance with principles which have stood now for 150 years.

“Protection of Inefficient Contractors”

The next criticism of the proposal seems to take the form of an encomium of the present system. Perhaps with tongue in cheek, although it is not possible to discern, the author of the Andersen Report says:

*“Although thought by many to be unfair and unjust the current payment system does have a general tendency to eliminate marginal operators. The Proposal might provide more protection to these businesses. It could also provide additional protection by taking sub-contractors outside the scope of the Federal Bankruptcy Act exempting them from its provisions.”*³⁸⁷

The Inquiry’s response

What the Andersen Report seems to suggest is that “the current payment system” in which contractors who have carried out their work in accordance with the subcontract are not paid as a result of the builders insolvency, which the author of the Report

³⁸⁶ Ibid. p 22.

³⁸⁷ Ibid. p22.

concedes is thought by many to be “*unfair and unjust*”, is somehow a good thing, because it has “*a general tendency to eliminate marginal operators*”.

It is unfortunate that the designation of some subcontractors as “marginal operators” would seem to involve the conclusion that their just claims are for that reason somehow undeserving and unmeritorious of being paid by the head contractor who has already been paid by the principal, for work the subcontractor has completed.

So, the critique seems to say, let us not give any protection to these “marginal operators” who have done their work and who have not been paid.

This proposition would astonish the most rabid Darwinian but it then goes on to say that additional “protection” could be provided to these marginal operators by taking subcontractors outside the scope of the Federal Bankruptcy Act. No support is ventured for this remark.

Perhaps what the author of the Report might have been referring to is the notion that a subcontractor who has a right to funds held in trust, is somehow given protection not available to the ordinary run of creditors. That in one sense is correct in that the trust fund does not ever form part of the bankrupt’s estate or fall into the property of the insolvent company. But that surely could not be what the author is driving at because it seems to be suggested in this paragraph of the Andersen Report that subcontractors will somehow not be within the scope of the Federal Bankruptcy Act and therefore exempted from its provisions. The statement is devoid of merit and does not warrant any further analysis, save to say that under Andersen, a “marginal operator” should perhaps not be entitled to be paid anyway.

“Breaching Corporate Veil”

As the Andersen Report proceeds its conclusions become more adventurous. It is said that:

“Directors may face increased exposure due to the creation of trust funds. The liability provided by the Proposal represents a significant addition to the exposure already faced by directors under the Corporations law. This could create a severe disincentive to persons of suitable expertise to take on the position of directors of the parties who will act as trustees. The Proposal does not make it clear whether criminal liability as well civil liability will apply to these directors. If criminal liability does apply it could add to the exposure already faced by these Directors pursuant to the Corporations law. Whether such disincentives should be introduced to a highly volatile industry which requires the input of talented individuals requires further consideration.”

Nor does the Proposal provide any test for liability in relation to a director. For example, in the Alberta Proposal³⁸⁸ the joint government and industry task force concluded that:

“The proposed legislation would expressly pierce the corporate veil and create personal civil liability for directors and officers who knowingly assent to, participate or acquiesce in conduct which they know or reasonably ought to know amounts to a breach of trust by the corporation.

Further, it may be difficult to pursue a non-resident director or entity because the jurisdiction of the Act will only apply to NSW.”³⁸⁹

The Inquiry's response

So be it. The Inquiry is of the view that “talented individuals” should obey the law like the rest of us. If a director pays trust money away, it is a breach of trust. If a wrongdoing director is faced with a civil penalty has it ever been a defence that the wrongdoer was a “talented individual” in a “highly volatile industry”?

“Payment of Variations”

The Andersen Report states that:

“There appears to be no proper processes for payment of variations. The Australian Federation of Construction Contractors has raised the problem of the head contractor’s representative ordering variations. They noted that the underlying basis for the Proposal is to establish the proof of capacity of the owner developer to pay for work done. It (the Federation) then posed the question:

“Will the architect/client’s representative be required to underwrite the client’s capacity to pay when ordering an onsite variation which will increase the project cost? Or will the variation be without effect until capacity to pay is proven?”

In response the SOPC stated:

“The Committee does not claim that the architect is responsible for the costs, it remains (the responsibility) of the client or contractor, but a sub-contractor in

³⁸⁸ “The Alberta Construction Payment Act (sic) – a proposal for a comprehensive statutory trust scheme supported by the pre-existing builders’ liens rights in the Province of Alberta, Canada.”

³⁸⁹ *Ibid.* pp. 22-23.

refusing to perform variations should not be placed in breach of contract, when knowingly in doubt about the ability of the client or contractor to pay”.

This does not seem to address the essential issue as to what processes are to be undertaken to ensure that the variations can be paid for. Additionally, it appears unfair that owners might have insufficient notice of variation. This might result in an unexpected quarantining of working capital.”³⁹⁰

The Inquiry’s response

The short answer to the silly question asked above is no.

A variation will be paid if the contractor can convince the owner it is entitled to be paid. Likewise for a subcontractor claiming upon a head contractor. If disputed, SOPA will resolve it. The trust neither adds or subtracts anything to that position. The critics of the trust say “there appears to be no proper processes for payment of variations.” Once again it is impossible to understand how the trust itself could take account of claims for variations. If there is a claim for a variation made by the head contractor upon the owner then that is taken into account because it will, if it is a legitimate claim for a variation, be paid into the construction trust.

If it is not paid into the construction trust then the head contractor will have a claim under SOPA to compel interim payment.

If it is a claim for variations as between the subcontractor and the head contractor then precisely the same considerations apply. Once again SOPA has overtaken and rendered these criticisms completely irrelevant.

“Revenues Forming the Trusts”

“The Proposal notes that the following moneys for which the owner will be trustee include the following:

- *funds advanced under a mortgage, or other security to, or on behalf of, the owner for the purposes of financing the improvement;*
- *any revenue generated from the improvement, subject to prior encumbrances;*
- *any funds derived from the sale of the improvement, subject to normal expenses and prior encumbrances; and*

³⁹⁰ *ibid.* p.23-24.

- *the net proceeds for insurance, should the improvement be damaged or destroyed.*”³⁹¹

The Inquiry’s response

The Inquiry’s recommendation does not include the proposal which attracted the criticism. It may be disregarded – all four points.

“No provision for project running at a loss”

This particular criticism if it may be so described, brings to mind the cargo cult in the Highlands of Papua and New Guinea. What the authors of the Andersen Report have said concerning the SOPC proposal is that:

*“There is no provision for the situation where a particular project is running at a loss and claims by the creditor exceed the balance in the accounts held on trust at any one time. It may be that all the monies available in the account will be paid to the creditor with a shortfall becoming an ordinary debt to be recovered in accordance with existing debt recovery and insolvency laws. This, however, is not clear nor are the implications of such a situation.”*³⁹²

The Inquiry’s response

The Andersen Report has answered its own question; *“the shortfall will become an ordinary debt to be recovered in accordance with existing debt recovery and insolvency laws.”*

How could a construction trust, which can only be fed by payments from the owner, alter the position where there are insufficient moneys in the account to meet valid claims? If the claims are not valid and SOPA so decides, then the issue falls away.

It is difficult to determine what the author of the Andersen Report could have meant when writing that *“there is no provision for the situation where a particular project is running at a loss and claims by the creditor exceed the balance in the accounts held on trust at any one time.”* However, the answer to the apparent inquiry is as follows:

- The owner is only obliged to pay into the trust account moneys it is legally liable to pay to the head contractor under the contract it has with the head contractor.
- If the project is running at a loss, that in no way affects the amount of money being paid by the owner into the construction trust account.

³⁹¹ Ibid. p.24.

³⁹² Ibid. p. 23.

- If the amount of money in the trust account is not enough to satisfy the amounts claimed by the subcontractors then that is a fact and the trust proposal never held itself out as one capable of producing money out of thin air.
- In cases where there are insufficient moneys in the trust the position is no different from that in which the subcontractors are not being paid because of the builders' impecuniosity.
- The subcontractor will still have its legal claims against the head contractor, it will still have its rights under SOPA and it will have a right *in rem* against the fund in respect of those funds that are in the account. Finally it will have its right to be paid within 28 days and failing that the imposition of penalty interest.
- Everything will depend upon the reasons for the project loss. Each reason has its own consequence.

To each variant is a simple answer compatible with the trust, wrongful payment by the owner, tender miscalculation by the head contractor, head contractor incompetence and so on.

“Owner-Builder Employees Certain Propositions or Questions Raised”

The Andersen Report states:

*“Employees of owner/builders may rank behind sub-contractors and their employees as creditors. While the SOPC has argued that payment for wages will form part of the certified claim for which payment is received from the trustee above, it does not consider the position of employees of a head contractor/developer. Such employee wages will not form part of any certification and, prima facie, will rank behind the claims of sub-contractors and, in effect, the employees of sub-contractors.”*³⁹³

The Inquiry's response

With respect, that is simply misconceived. Payments due to the head contractor are included in the principal's progress payment and may be accrued as soon as the head contractor pays the subcontractor.

“Interest earned”

The Andersen Report states:

³⁹³ *ibid.* p. 23.

*“The proposal makes no mention of how interest earned on trust funds is to be dealt with.”*³⁹⁴

The Inquiry’s response

That is not the case in relation to the present proposal. A specific recommendation makes provision for the interest earned on the funds for the time they are on deposit before falling due for payment to subcontractors, to be retained by the head contractor.

“Administrative Cost Burdens”

The Andersen Report went on to state:

*“There are also some major administrative burdens which would affect the industry. Chief amongst these is the issue of increased accounting workload, which may affect smaller contractors most. A higher level of monitoring of amounts in bank accounts will be required, with sophisticated book-keeping generally needed throughout the trust chain, so as to ensure monies forming the trust monies are continually maintained at a level to allow potential payouts.”*³⁹⁵

The Inquiry’s response

Yes the account will have to be monitored presumably as it would have been in any event. If the trust moneys are paid out as they should be, there is no question of them being *“continually maintained at a level to allow potential payments.”* There is no question of *“maintaining levels.”* The account can only contain what the owner puts in.

The other criticisms are of no particular relevance except for the now familiar criticism concerning *“administrative cost burdens”* and here the report quotes a commercial manager, major head contractor who apparently said that *“we would have to employ at least another 2 to 3 full time accountancy staff to meet the proposals provisions.”*³⁹⁶

In the view of the Inquiry such a statement is of no application to the proposal which has been recommended. It rates as hyperbole which is seldom helpful.

Summary

Some of the above criticisms are intrinsically and self evidently wrong and say more about the unsourced and unproven nature of the criticism itself. Many of them are

³⁹⁴ Ibid. p. 24.

³⁹⁵ Ibid. p. 26.

³⁹⁶ Ibid. p. 26.

contradicted by the analysis and experience of expert witnesses who gave evidence to the Inquiry, others are speculative, still more are legally unsound. Others are merely questions, which have been answered.

1991 Queensland Discussion Paper

The authors of the 1991 Queensland Discussion Paper also attempt to emphasise “*the difficulties of determining which funds must be kept by the owner on trust...*” This distraction has already been dealt with by the Inquiry.

The Inquiry’s response

The criticism of the statutory trust in this report is akin to the setting up of a straw man simply for the purposes of knocking him over. Paragraphs such as the following:

*“Further, the pragmatism of requiring the building industry to invest itself with the character of mandatory trustees must be regarded with some scepticism. Complexity creates cost as (even assuming the best of faith) parties who are unsure of their position must seek advice and litigate in order to operate even on a normal day to day basis. This is the very ailment that afflicts the industry at present.”*³⁹⁷

are so vague and generalised as to be of no value.

Then in a similar way the Committee draws unsubstantiated general conclusions:

*“Such legislation would also have an impact upon the lending practices of financiers. This may be reflected in a reluctance of financiers to grant or extend credit to builders where their sole source of income is subject to a statutory trust in which they (financiers) have no beneficial interest.”*³⁹⁸

The Inquiry’s response

What this paragraph in fact concludes is that it is in order for financiers to intervene in the construction payment process whenever they see fit in order to intercept the payment of funds to subcontractors which were only ever intended to be paid to subcontractors. Any approach which endorsed that deliberate intention would be for the reasons the Inquiry has pointed out earlier, be against good conscience. However those who subscribe to that approach will for that reason reject the construction trust.

³⁹⁷ 1991 Queensland Discussion Paper, p. 41, para 3.1.

³⁹⁸ 1991 Queensland Discussion Paper, p. 41, para 3.3.

Then the 1991 Queensland Discussion Paper repeats the loose and unsubstantiated conclusions:

“Other costs would flow from a requirement to stringently supervise the accounts to avoid breaches of trust, particularly in circumstances where such breaches would attract loss of licence. The overhead costs to the numerous parties of engaging accountants and lawyers to advise them upon their rights and obligations would be substantial.”³⁹⁹

The Inquiry’s response

Andersen’s dream of a long feast for accountants and lawyers is unlikely to become a reality.

Nextly the criticisms then go on to say:

“for persons entirely unconnected with the building industry, new difficulties would arise in dealing with industry “trustees”. This is because of the capacity to trace trust funds into the hands of innocent third parties and recover. In a sense then, the difficulty in which the industry finds itself at present would be spread across the entire community and affect everyone with whom members of the building industry transact any business.”⁴⁰⁰

The Inquiry’s response

The use of hyperbole in this way does not assist a rational debate. The criticism is not valid.

In a mystifying about face after addressing all of those criticisms of the Alberta Bill the 1991 Queensland Discussion Paper went on to say that “***a single trust requirement for builders would solve some (but not all) of the abovementioned problems***” (emphasis added).

With this endorsement the Inquiry completely agrees. The 1991 Queensland Discussion Paper then went on to say that if clause 9 of the Alberta Bill, were enacted here in Australia, the following could be expected.

General Trust

³⁹⁹ 1991 Queensland Discussion Paper, p. 41, para 3.4.

⁴⁰⁰ 1991 Queensland Discussion Paper, p. 42, para 3.5.

4.2 If clause 9 of the Alberta Bill were enacted here, the following could be expected:

- **There need be no problem of uncertainty over the trust character of monies received by the builder. At the time of claiming its progress payment, the builder could certify what work had been performed and materials furnished by other persons and what amounts were to be payable in respect of same. Such amounts collectively would constitute the trust property. Accordingly, identification would be clear at the time of receipt by the builder.**
- **Consolidation trust account provisions similar to the Albert Bill could be adopted. The bookkeeping difficulty could only be overcome by a massive training investment by the licensing authority.**
- Consequences of tracing trust money into the hands of innocent third parties would still persist; however, by reducing the trust hierarchy to a single layer trust, the extent of this problem would be markedly reduced. The same is true of costs associated with the trust-keeping.
- Builders presumably would not be happy to be the only party in the contractual chain to keep trusts. It may be that at first glance, this would seem unfair. **However, balanced against that must be the consideration that it is the builder sector of the industry which is notorious for default and failure (see chapter 2). Further, it is the builder sector which causes the complexity in the first place by choosing to avoid obligations to its workforce by means of subcontracting (via-a-viz employment). Further, builders already exercise control over their subcontractors' payment of those lower down in the contractual chain by means of contractual requirements (see paragraph 3.18 of chapter 3). Finally, as to the likelihood of the owner defaulting/collapsing, the builder is the only party in the contractual chain who is remotely capable of assessing the credit worthiness of the owner: the risk allocation provisions would dictate that it is the builder who should then bear that risk.**

Conclusion

5.1 The Alberta Bill is complex, costly, unrealistic in its expectation of the building industry to become expert account keepers, and will be instrumental in spreading the problems of the building industry throughout the rest of the commercial community. While it is possible that some refinements may be made to fit the Australian context, it is unlikely that a comprehensive trust hierarchy could ever be seriously contemplated for the building industry.

5.2 Single trusts, however, would work and indeed as noted earlier, some well administered building companies may well find themselves in the position to opt for trusts as the most favourable way of securing payment for their subcontractors. Irrespective of that option, all builders could reasonably be required to maintain trusts for subcontractors' retention money.⁴⁰¹ (emphasis added)

The 1991 Queensland Discussion Paper contained a number of propositions in its commentary on the construction trust which are analysed below.

It is important firstly, to again emphasise the misuse of the term “cash-flow”. That term should not be equated with a general “free for all” which enables building contractors to use the progress payments earned by subcontractors in any way they think fit. The fullest, most accurate and essential use of the term cash flow should be in the context of paying lawful debts incurred to subcontractors rather than diverting the funds from the project to the kind of foreign purposes identified earlier in this Report.

The 1991 Queensland Discussion Paper endeavoured to deal with the trust requirement and said that it had paid careful regard to the Alberta Task Force which had rightly noted that:

“The imposition of a statutory trust will have a profound effect on the manner in which the construction and oil and gas industries conduct their business. It would transform what would otherwise be debtor creditor relationships into fiduciary ones where failure to pay accounts will no longer be merely breaches of contract, but rather will become potential breaches of trust.

Consequences include:

- *beneficiaries may sue not only for damages but also for recovery for the trust property (even tracing it into third party hands),*
- *company Officers and Directors can be held personally liable for the breaches of trust*
- *trust property is not part of the bankrupts estate,⁴⁰²*
- *civil and criminal sanctions apply to breaches of trust.⁴⁰³*

Asking speculative questions then not carrying out the analysis required to answer them is not helpful. Yet these are not negative or critical propositions. Each of them commends the statutory construction trust and each of them refers to positive characteristics which have made the trust an appropriate remedial device.

⁴⁰¹ 1991 Queensland Discussion Paper, pp. 42-43, paras 4.2-5.2.

⁴⁰² Nor by parity of reasoning is it part of the property available to creditors upon insolvency.

⁴⁰³ 1991 Qld Discussion Paper, p.37 at par 2.10, Quoted extract is from Alberta Task Force Report, p. 11.

The 1991 Queensland Discussion Paper then went on to analyse a bill which had been prepared in the Canadian province of Alberta. Much of the criticism made in that paper is specifically concerned with aspects and features of the proposed Alberta Trust.

In the 1991 Queensland Discussion Paper the point is made that the relevant Alberta provision:

“...is sufficiently certain to enable clear definition of which monies received by contractors and sub-contractors respectively are trust monies. That is not to say that there won’t be disputes over whether a contractor or sub-contractor “owes money” to others; for example, where a contractor receives a progress payment in respect of work performed by subcontractors, but at the time of his payment the contractor is not obliged to pay the subcontractors for a further 45 days: is any portion of his progress payment “trust monies” at the time of its receipt? One would have thought the answer to be “no”, yet if that were the case, subcontractors would continue to be unprotected by the trust provisions (at least until the holder receives the next progress payment) prompt payment rules or alternatively a wider definition of the monies to constitute trust property would resolve the issue.”⁴⁰⁴

The Inquiry’s response

None of these criticisms apply to the proposed statutory construction trust recommended by the Inquiry. The suggested draft legislation makes it abundantly clear that the difficulty as to when the moneys become trust moneys is clearly resolved. In that event the answer is not “no” it is “yes” with the result that in the terms of the Queensland analysis, subcontractors would be protected by the trust provisions.

Then the 1991 Queensland Discussion Paper concluded that:

“All trust monies in respect of all projects can be placed in one fund. This is an entirely reasonable provision except that the practical reality of contractors and sub-contractors in the building industry is that they do not keep good books of account.”⁴⁰⁵

⁴⁰⁴ 1991 Queensland Discussion Paper, p.39 at para 2.22.

⁴⁰⁵ 1991 Queensland Discussion Paper, p. 40 para 2.24.

The Inquiry's response

The Inquiry does not recognise for a moment that this is a valid reason not to implement the trust. It is akin to saying that there is an extremely good idea which will protect subcontractors but we should not implement that idea because subcontractors do not keep good books of account and even though they are informed of the benefits of this proposal they will still obdurately refuse to keep good books of account.

That unsound approach is not in accordance with the way the Inquiry understands human nature to operate. If it is the fact that book keeping is not one of the skills in the industry and if it is the fact (as has been found on other occasions) that the failure to keep good books of account is one of the causes of insolvency, then rather than point to that circumstance as a reason not to reform the law, the Inquiry respectfully suggests that the sensible course is to remedy the real mischief and ensure that there are compulsory courses conducted to bring the standard of book keeping up to scratch. The Inquiry has formulated recommendations dealing with education.

The need to improve the financial management skills in the industry was made clear in submissions to the Inquiry and in meetings held with different parties. Recommendations made by this Inquiry relating to education are a fundamentally important part of the overall recommended package of reforms.

In its submission, the MBA make the point that:

“Better management is associated with higher levels of skill and education and government efforts to facilitate the operation of the economy with better levels of education is a vital role and one that needs attention in the current context.”⁴⁰⁶

This point is also made by Grenon in an article entitled “*Common Law and Statutory Trusts: In search of Missing Links*”:

“Similarly, s. 7 of the Travel Agents Act of British Columbia provides that money received from a traveller, tourist or sightseer by a travel agent or travel wholesaler carrying on business in the province shall be deemed to be held in trust for the person who paid it. Section 10 of the Rental of Residential Property Act of Prince Edward Island provides that a security deposit taken from a lessee by the lessor shall be held in trust by the lessor and, if in money, shall be deposited in a trust account at a chartered bank, trust company or credit union within the province. Section 124 of the Insurance Act of Alberta is to the effect that an agent or broker who acts in negotiating, renewing or continuing a

⁴⁰⁶ MBA submission to the Inquiry, 7 November 2012.

contract of insurance with an insurer licensed under this Act and who receives any money or substitute for money as a premium for such a contract from the insured shall be deemed to hold the premium in trust for the insurer. Similar laws can be found in all common law provinces and n federal legislation. The policy behind them is clear. They seek to ensure that certain sums paid by, or held on behalf of, certain persons will continue to benefit them, notwithstanding bankruptcy, insolvency, execution or attachment proceedings involving the holder of these sums. Lawmakers have concluded, as a matter of policy, that certain persons, who are often consumers, employees or small business entrepreneurs, are entitled to such protection.”⁴⁰⁷

The 1991 Queensland Discussion Paper then went on to emphasise that:

“certainly solicitors, real estate agents and a number of other groups in the community are required to operate trust accounts.”⁴⁰⁸

The Inquiry's response

In spite of what the 1991 Queensland Discussion Paper had earlier stated, the conclusions expressed about the construction trust were:

“On the basis of what is currently known about the building industry’s book keeping diligence, it may be altogether too fanciful to expect the industry to leap to the other end of the bookkeeping spectrum and comply with trust obligations.”⁴⁰⁹

It is the firm view of the Inquiry that this is an altogether incorrect basis upon which to proceed. In the Inquiry’s view the bottom should be brought to the top and not the top to the bottom.

Paragraph 2.28 of the 1991 Queensland Discussion Paper (under the heading ‘Sanctions’) refers to the Alberta Bill, which provided that contractors, subcontractors and sub subcontractors have rights to demand certain information from the owner, and the contractor.

⁴⁰⁷ Grenon, A., “Common Law and Statutory Trusts: In Search of Missing Links” (1995-1996) 15(2) *Estates and Trusts Journal* 109 at 111.

⁴⁰⁸ 1991 Queensland Discussion Paper, p. 40 para 2.26.

⁴⁰⁹ 1991 Queensland Discussion Paper, p. 40 para 2.27.

This information request system is not complicated and is restricted to a proper inquiry about the state of accounts between specified parties whether a certain subcontractor's work has been certified as complete, whether or not the owner is paid particular moneys and whether other subcontractors have been paid. In the words of the 1991 Queensland Discussion Paper with which the Inquiry is entirely in agreement:

“Clearly, disclosure of such information is designed to reduce the level of disputation about the exact state of affairs between trustee and beneficiary.”⁴¹⁰

This undoubtedly uncontroversial conclusion is contrary to a number of gloomy and unsupported speculative statements in the Andersen Report.

The 1991 Queensland Discussion Paper, assisted by its reading of the Alberta Bill also took the view that the obligations of the trustee were not altogether onerous. The Inquiry agrees.

The first of these was *“to place trust monies in trust account.”*⁴¹¹ The Inquiry has already made the point that it will be necessary for the moneys to be placed into a separate trust bank account in any event. To avoid title resting with the head contractor, under the Inquiry's proposal the principal pays the progress payment directly into the trust account.

The 1991 Queensland Discussion Paper went on to conclude that:

*“Not to do so would in and of itself amount to breach of trust.”*⁴¹²

The Inquiry agrees.

Then the second requirement imposed upon the trustee as identified correctly by the 1991 Queensland Discussion Paper was that:

*“...to the extent that there is money owing, whether due or not, the deposited money must be retained in the trust account and ultimately applied to the payment of those accounts when they become payable.”*⁴¹³

With this eminently clear statement of the position, the Inquiry respectfully agrees.

⁴¹⁰ 1991 Queensland Discussion Paper, p. 40 para 2.28.

⁴¹¹ *Ibid.*, par 2.29.

⁴¹² *Ibid.*

⁴¹³ *Ibid.*

1994 CIDA Final Report

The CIDA Report records a recommendation that;

“.....all contracts contain a provision for the payee to establish a trust fund for cash retentions. That CIDA investigate options for the establishment and management of such trust funds.”⁴¹⁴

The CIDA Action Team received 32 responses. Twenty four respondents supported the recommendation some with qualification.

While it is true that this recommendation was confined to a trust fund for cash retentions, nevertheless, the strong support for it is of significance.

1996 Price Waterhouse Report

In July 1996, Price Waterhouse submitted a consultancy report which it prepared for the National Public Works Council Inc (NPWC) entitled *Improving Security of Payment in the Building and Construction Industry* (“the 1996 Price Waterhouse Report”).

In its consultancy, one of the issues for determination by Price Waterhouse was whether or not a trust would be a sufficient vehicle to provide adequate protection for security of payment for work done and materials supplied by a subcontractor. In the Inquiry’s view, the Price Waterhouse Report is infinitely superior to the Andersen Report in its treatment addressing the trust option. Note that SOPA was enacted after the Price Waterhouse Report.

As part of its brief, Price Waterhouse was asked to consider a number of specific questions on trusts “from both a legal and insolvency perspective.”⁴¹⁵ Each of those questions, together with the Price Waterhouse answer and this Inquiry’s comments on the Price Waterhouse answer are set out as follows.

4.8.1 Is legislation required to enable legal redress for the misuse of monies required to be held "in trust", or is a contractual requirement sufficient?

Whilst in theory proper contractual requirements ought to be sufficient for the proper policing of monies held in trust, the realities are such that legislation should be introduced to cover misappropriation of trust monies. Misappropriation of trust monies is more likely to occur where the trustee is

⁴¹⁴ CIDA Report, p. 45

⁴¹⁵ Price Waterhouse Report, pp. 41-54, section 4.8.

one of the parties in the contractual chain under a building and construction project. Where a trustee is a third-party Government body, mis-use of trust monies is less likely to occur. Civil remedies are available for a breach of trust pursuant to the various Trustee Acts enacted in each State. Further, damages are available at common law for breach of contract and negligence. Where there is a situation of fraud or theft, criminal penalties are available. The difficulty with policing fraud in financial matters is one relating to general proof. The issues involved are complicated and generally Juries are not sufficiently sophisticated to deal with technical financial transactions. If the trustee is to be either the Head Contractor or other Subcontractors down the contracting chain, it should be a requirement to continue to hold a licence under building licensing regulations, that a Head Contractor or Subcontractor shall not have committed a breach of trust. Further, legislation should be implemented to make it a criminal offence for a misappropriation of trust monies knowing that such monies were identified for a specific Subcontractor. Such criminal offences would equally have to cover directors and officers in the event that the Head Contractor or Subcontractor was a corporation acting as trustee. (emphasis added)

The Inquiry's response

Broad agreement subject to the detail in the Inquiry's Report.

4.8.2 If monies held "in trust" are in an account which is allowed by the trustee (the Contractor) to be drawn down below zero or at least below the level of the total value of monies required to be held "in trust", what effect does this have on the rights of the trust beneficiaries?

The fiduciary nature of the obligations of the trustee dictate that such a position should not arise. The trustee should not allow funds to be paid out of trust in excess of the obligations of the trust and the trustee should at all times ensure that sufficient monies are held in trust to meet its obligations. However, if such a situation occurred, Subcontractors would not obtain full payment for work and materials supplied. A proper accounting would be required to determine why insufficient monies were in the account. Under those circumstances, it may be that civil and/or criminal prosecution should be sought against the trustee. However, what is to be done to those Subcontractors still owed monies pursuant to the trust? Should Subcontractors be paid on a "first come best dressed" basis or should they be paid on some more equitable basis such as a pari passu basis? A "first in best dressed" basis is inequitable. It is submitted that equitable principles dictate that payment should be made on a pari passu basis.

The Inquiry's response

Broad agreement subject to the detail in the Inquiry's Report.

4.8.3 Current advice is that the banking system does not allow the identification of separate deposits or withdrawals made on the same day. It has been suggested that this will make it impossible to identify how much trust money "is owed by or owed to whom", that is, monies are no longer traceable. Clarify this and advise what effect this would have on either types of trust proposal if records from a defaulting Head Contractor were not available.

Our advice is that the banking system does allow the identification of separate deposits or withdrawals made on the same day. Therefore, monies are traceable. The banking system runs on a "next day" basis, ie deposits and withdrawals made on a day can be traced the following day via "online" reports which give full details of all credits and debits that transact on an account on the previous day. The report records all transactions from the previous day irrespective whether the funds have cleared or not. Therefore, the monies are traceable. However, if a request to trace particular monies was made on the same day as the transaction, the Bank can only identify that a particular deposit or withdrawal has occurred; a Bank is not able to identify where the particular monies have come from or gone to. This practicality only presents a timing delay as the transaction can be traced on the following day. Accordingly, in general, it is possible to identify how much trust money "is owed by or owed to whom". Where there is one trust account used to administer a pool of funds for many projects (ie multiple trust), the identification of trust monies available for distribution to specific Subcontractors may become blurred where insufficient records have been kept by the trustee. If there was a defaulting Head Contractor, it may be difficult, if not impossible to determine what monies were available in the trust for distribution to Subcontractors. In summary, if records from a defaulting Head Contractor were not available then trust monies may not be readily traceable. This would be readily apparent where "cash" monies are deposited or withdrawn by the Head Contractor and the cash books recording receipt or payment of the monies were not "available" from the Head Contractor. The "cash" would only be traceable if the serial numbers of the notes were recorded by the payee in respect of a receipt to a Head Contractor and the Bank in respect of a withdrawal by the Head Contractor. Accordingly, in reality, a "cash" transaction would not be traceable. However, where monies are held in trust pursuant to a specific written trust, with proper administering

procedures in place, the same situation would be unlikely to occur, because monies would be held in separate identifiable accounts.

(emphasis added)

The Inquiry's response

Broad agreement subject to the detail in the Inquiry's Report.

4.8.4 If monies held in trust are misused by a Head Contractor and not replaced, and then the Head Contractor fails or is placed into receivership, what legal action is available to the Subcontractor against the trustee, ie the Head Contractor?

The Subcontractor would be able to institute civil proceedings against the trustee for breach of trust and perhaps for breach of contract and/or negligence. Provided the Head Contractor has sufficient funds available to meet a judgment debt, the Subcontractor ought to be paid. However, where trust monies are not easily identifiable, a dispute is likely to arise as to whether the monies available for distribution should go to the Subcontractor or the Receiver. Whether the Receiver takes priority will be dependent upon whether the charge was fixed or floating. If the charge is a floating charge, the actual time of crystallisation of the charge will become important. If the charge is a fixed charge, the time of the breach of the debenture will then become important. A simple answer to this issue cannot be given. The answer will depend on the facts and circumstances of each individual case.

The Inquiry's response

Broad agreement subject to the detail in the Inquiry's Report.

4.8.5 If a Head Contractor fails and there is some money which is held in trust still left, is payment of these monies to the appropriate Subcontractors a preferential payment?

We have assumed that in answering this question the reference to "fails" means that the Head Contractor is placed into some form of insolvency administration. The process of an insolvency administration falls into two categories, namely corporate and personal insolvency. There are different forms of both corporate and personal insolvency, however, for the purpose of answering the question at hand we will only consider the forms of insolvency that a preferential payment has a direct impact on.

These forms of insolvency are as follows:

- Liquidation
- Bankruptcy
- Deed of Assignment

The issue of preferential payment does not apply to Receivership and accordingly, a Receiver does not have recourse to such a payment. Briefly, a preferential payment is voidable against the Liquidator or Trustee in Bankruptcy, ie the Liquidator or Trustee in Bankruptcy will have recourse against the payment. Preferential payments are governed by Section 565 and 588FA, FC and FE of the Corporations Law and Section 122 of the Bankruptcy Act. Basically, the above provisions apply if:

- (i) a debtor and creditor are parties to a transaction;
- (ii) the transaction results in the creditor receiving payment for an unsecured debt, more than the creditor would receive from the debtor if the transaction was set aside and the creditor was to prove for the debt in a Liquidation/Bankruptcy of the debtor; and
- (iii) the transaction occurred within the relevant time period to be classified as a preference payment.

The transaction would be considered a preference payment even if the transaction was entered into because of an Order of an Australian Court, a direction of an agency or pursuant to the terms and conditions of legislation (not including the Corporations Law or Bankruptcy Act). A Liquidator or a Trustee in Bankruptcy is entitled to void the payment only if the transaction involved the dissipation of assets which would otherwise have vested as assets in the Liquidation or Bankruptcy and the beneficiary was a creditor. **It is well settled that if property was held on trust and a repayment was afforded to a beneficiary or claimant prior to either Liquidation or Bankruptcy, such a transaction would not be considered a preference (under either Section 565 or 588FA of the Corporations Law or Section 122 of the Bankruptcy Act), as the claimant or beneficiary is not a creditor. The above assumes that the trust arrangement is embodied within the trading activities of the corporate trustee. This is the basis on which we have considered the use of trusts by a corporate trustee to afford security to the Subcontractors. The proposition can be different if the company was acting as trustee under a trading trust arrangement and in certain circumstances, the monies are recoverable as voidable dispositions. However, this is considered outside the scope of this Consultancy and we make no further comment.**

(emphasis added)

The Inquiry's response

Broad agreement subject to the detail in the Inquiry's Report.

4.8.6 What rights does a liquidator (or Trustee) have to monies: - deemed to be held in trust and - held in a formal trust account?

(i) Bankruptcy

Where the trustee of the trust is a natural person it appears that the trust assets do not vest in the Trustee in Bankruptcy, ie the Trustee in Bankruptcy would not have any rights to the monies held in trust. Accordingly, the monies held in trust would be able to be disbursed to the beneficiaries in accordance with their respective rights. Monies paid to Subcontractors would not be considered a preference payment. If there was a shortfall in payment of the amount owed to a Subcontractor, then the Subcontractor would be able to prove in the Bankruptcy for the shortfall. Property held in trust for another is exempt. Section 116(2)(a) of the Bankruptcy Act explicitly excludes property held by a bankrupt in trust for another person. The trust property must be capable of being distinguished (ie identifiable) from other property of the bankrupt. The trust property remains vested in the trustee subject to the normal claims by creditors as set out in the authorities.

(ii) Liquidation

There is no statutory exemption for trust monies given pursuant to the Corporations Law. However, individual items of trust property are exempt under the general law. When a company is the trustee holding monies in trust and is subsequently placed into Liquidation, the trust property is not available for distribution to general creditors. A beneficiary, unlike a creditor, can stand outside the liquidation and assert an equitable proprietary interest in the trust property, unaffected by general creditor claims. (emphasis added)

(iii) Application to both Bankruptcy and Liquidation

The trust property must be capable of being distinguished from other property of the individual or company. If the trust funds have been dissipated, then no property remains exempt. Trust creditors have no exclusive claim to other property of the bankrupt or insolvent company. The need to identify trust property gives rise to the procedure of tracing trust property into other property to which it has been converted, as the converted

property remains exempt.⁴¹⁶ Where those monies cannot be specifically identified pursuant to a trust, a dispute may arise as to whether those monies are monies of the individual or company or the Subcontractor. If trust property is somehow mixed with the bankrupt's or company's own property, it has been settled in *Frith v Cartland* (1865) 34 LJ Ch 301 that the whole of the property would be treated as trust property, except that specifically distinguished as non-trust property. If money was held by the bankrupt or company in a fiduciary capacity and was paid into a simple bank account, the claimant should be able to trace the monies. Accordingly, the monies would then, in effect, be charged and available to settle any account owing to the claimant. If a Bank then mixed funds with the bankrupt's or company's own monies and the bankrupt or company subsequently drew upon the mixed account, the effect of the decision in *Re Hallet's Estate; Knoathbull v Hallet* (1879) 13 Ch 696 means that the bankrupt or company will be deemed to have taken out his own monies in preference to the trust money. However, as was held in *Roscoe Ltd v Winder* (1915) 1 Ch 62 the trust monies in the account can only be represented by the reduced balance. It makes no difference whether the monies are deemed to be held in trust or are held in a formal trust account. Where there is a mixing of funds without proper identification of those funds, problems will always arise in the eventuality of a liquidation or bankruptcy. Accordingly, it is clearly preferable to have a requirement that monies held in trust shall be specifically held in a separate trust account with the identification of those monies earmarked for a specific Subcontractor.

(emphasis added)

The Inquiry's response

Broad agreement subject to the detail in the Inquiry's Report.

4.8.7 If the obligation to hold monies in trust, whether deemed or otherwise, is only for one level in the contractual chain, that between the Head Contractor and Subcontractors, does the Principal or client/owner have any fiduciary obligations towards a Subcontractor if the Head Contractor defaults?

It is unlikely that the law, as it currently applies, would deem a Principal to have fiduciary obligations towards Subcontractors of the Head Contractor where there is no privity of contract between them. However, a contract might create a deemed trust and the Principal may be held to be a fiduciary of the Subcontractor. Clear terms in the contract would be required to the effect that

⁴¹⁶ Note the Inquiry's recommendations.

monies held by a Head Contractor were held on trust for a specific Subcontractor or Subcontractors, otherwise a fiduciary obligation would not be imposed upon a Principal.

The Inquiry's response

Broad agreement subject to the detail in the Inquiry's Report.

4.8.8 What methods of recovery are there for trust beneficiaries on monies paid out by the trustee (Contractor) improperly to another party following the Head Contractor's insolvency?

Beneficiaries are not creditors of the Bankruptcy or Liquidation per se. Their right to claim against the property lies where there is insufficient trust property to settle their account. Failing the availability of trust property, the claimant will inevitably have a creditor's claim against the Bankruptcy or Liquidation arising from a breach of trust or breach of contract. If the Contractor misappropriates monies knowing that they were trust monies, it may be that a criminal prosecution could be instituted against the Contractor for fraud or theft. The criminal law may then impose a requirement as a term of penalty for payment to be made to the Subcontractor by way of restitution. A Subcontractor may be able to recover monies paid out improperly to another party by way of the doctrine of constructive trust. A constructive trust can attach to specific property which is not the subject of any express trust, but is held by a person in such circumstances where it would be inequitable to allow him to assert full beneficial ownership of that property. Under those circumstances, that person would hold the property as constructive trustee for the Subcontractor. A constructive trust will be specifically formed where monies are appropriated by way of fraud. Further, if the Trustee in Bankruptcy or Liquidator was aware of the existence of the exempt property, but failed to retain it for the claimant, then the claimant may have a claim against the Trustee in Bankruptcy or Liquidator personally. **If a Head Contractor improperly pays monies earmarked for a Subcontractor to a third-party, the Subcontractor is able to recover those monies pursuant to the doctrine of tracing. This is the equitable right of beneficiaries under a trust to follow assets to which they are entitled, or other assets into which they have been converted, into the hands of those who hold them.** At first instance, a Subcontractor would have to attempt to recover monies directly from the Head Contractor. A failure to recover those monies from the Head Contractor would enable the Subcontractor to apply the equitable doctrine of tracing to the third-party in order to recover those funds. Of course, if those funds were mixed with other funds it may be more difficult and,

in some cases, perhaps impossible to properly trace those monies as being the trust funds specifically earmarked for the Subcontractor.

(emphasis added)

The Inquiry's response

Broad agreement subject to the detail in the Inquiry's Report.

4.9.1 Must there be mutual sign-off by trustees before the distribution of trust funds, by the Principal, the Head Contractor and Subcontractor?

A Trustee should authorise or sign-off before there is any distribution of trust funds to any Principal, Head Contractor or Subcontractor. This is simply on the basis of the fiduciary duty of a trustee to satisfy itself that payments made out of trust funds are paid to the correct beneficiaries, always remembering that a trustee has a fiduciary duty to act bona fide in the interests of beneficiaries. With the trustee signing off before distribution, a check or counter-balance is put in place such that funds are paid to the party justly deserving them, rather than there being a misappropriation of funds. The Head Contractor should not, without trustee obligations, control the funds distribution as there is no check or counter-balance to ensure funds are paid to the correct party. In theory, the idea that all parties to a contract sign-off prior to any funds being distributed sounds plausible. However, in practice, the idea as a stand alone mechanism, without some form of effective dispute resolution mechanism, would not be effective. All parties to the contract would need to sign-off that work has been satisfactorily completed, with one dissident party effectively being able to control the cash flow and thus, the lifeline of a Subcontractor.

The Inquiry's response

Broad agreement subject to the detail in the Inquiry's Report.

4.9.2 How does the Head Contractor obtain a distribution from the trust fund for payment of his project management time and profit margin?

We assume that an independent third-party is acting as the trustee. A trust fund mechanism implies that a Head Contractor (who is not acting as the trustee) will be required to disclose commercially sensitive information such as profit margins to the trustees in order for it to substantiate payment. Accordingly, Head Contractors would be adverse to the introduction of trust scheme arrangements as their competitive advantages would be disclosed, unless there were

mechanisms in place to protect against the disgorging of such sensitive information. A trustee must be satisfied that any payments made to any party in the contractual chain are justified in the sense that the payments are properly made in accordance with the various contracts between the parties. It may be a term of the contract or trust deed that the trustee is not to impart sensitive commercial information to other parties within the contractual chain. Under those circumstances, the trustee may well be aware of the profit margin of the Head Contractor, but is not permitted, pursuant to contract, to advise any other parties in the contractual chain of that profit margin, including the Principal. Furthermore, the fiduciary duty of the trustee would most probably prevent him from disgorging any such information. Where the trust mechanism provides for the Principal to act as trustee, such problems would probably not arise. In the ordinary course of events, a Head Contractor would provide the Principal with perhaps an hourly rate when negotiating the primary contract. To a large degree, the profit percentage that accrues to the Head Contractor under that hourly rate is of no concern to the Principal, as it should only be concerned with what the hourly rate is. To improve the security of Subcontractor payments it would be prudent for the Head Contractor to receive payment only for his base project management time, with the profit margin of the time being distributed to the Head Contractor once all other monies have been correctly dissipated. However, this may lead to the practice of the Head Contractor "loading" his project management time rates to compensate for the lead time for receiving payment of his profit margin and thus removing the protection afforded to Subcontractors through the use of trusts.

The Inquiry's response

In the Inquiry's proposal, the amount paid by the principal into the trust fund includes whatever the head contractor is entitled to be paid in that payment. Once the head contractor has paid the subcontractors it is entitled to access the fund to take out its entitlement.

4.9.3 The concept should address the issue of cascading trusts (Head Contractor to Subcontractor to Sub-Subcontractor), although the consultancy Brief excludes cascading trusts.

We have previously addressed the issue of cascading trusts in this Consultancy from a legal perspective. The use of such trusts from a commercial perspective is feasible, but with the structure of such trusts being commercially complex and costly. Administratively, the use of such trusts would be onerous and burdensome, with the result being that all parties associated with the trusts being faced with "paper warfare". However, when balanced with the legalities of the

various trust structures, cascading trusts are probably more efficient than simple or multiple trusts.

The Inquiry's response

Broad agreement subject to the detail in the Inquiry's Report.

4.9.4 The proposition would need to deal with projects which may be running at a loss where there are no fund inflows from the Principal as it is the Head Contractor who is funding the loss.

A Head Contractor would not want to fund a loss and, in all likelihood, would not be in a position to fund the loss. A Head Contractor would most likely not have sufficient "free cash" to hold in trust and a financier would most likely be reluctant to lend monies for such a purpose, unless it was able to obtain some form of security against the monies lent. However, unless the Head Contractor was able to fund the loss, the trust mechanism would not be able to be implemented and therefore, the security of Subcontractor payments would not be protected.

The Inquiry's response

This is irrelevant. The head contractor does not fund the trust the Inquiry has recommended. Moreover, "free cash" is not held in trust.

4.9.5 What will be the position with variations to the Building contract?

This issue envisages a situation where a Head Contractor or Subcontractor files for a variation to the contract. Standard building contracts provide for variations to allow for the situation where a Head Contractor or Subcontractor will need to ask for payments over and above what is already provided for in the contract. Assuming that the price of the contract is required to be varied up or down because of some eventuality which has occurred during construction, if the trustee is satisfied with the variation, then the trustee could ask the Principal for further payment into trust. Presumably this would be done pursuant to contractual arrangement at the start of the project. The trustee would be under an obligation to ensure that the variation was appropriate and thus it may be that the trust arrangement would have to provide for the trustee to approve any variations to the contract before they are made. Deciding whether the variations were valid would be administratively onerous and burdensome and may be outside the expertise of the trustee who could not then act without additional third party advice. Unless some percentage of funds are retained in trust to fund

the variations, the Head Contractor would, in the first instance, be required to fund the variations. This could be costly and affect profit. There would need to be a time limit applied to the retention of monies in trust. It would be impractical for the trust to continue infinitum.

The Inquiry's response

This is irrelevant. No moneys are to be retained in the trust account to fund future variations. Moreover, a head contractor is always required to fund approved variations in the first instance.

4.9.6 Could trust funds stop unethical conduct or unscrupulous behaviour?

The use of trust funds will not stop unethical conduct or unscrupulous behaviour. It is impossible to fully legislate against this type of conduct. Even if it was possible to legislate, it would be impossible to police and completely eradicate. Morally, such conduct and behaviour will not be tolerated. However, such tactics have existed for some time and human nature being what it is, total eradication will not be possible. The example Code of Practice for Security of Payment in the Building and Construction Industry is built on the principles of honesty, integrity and good faith. In particular it states that no participant in the industry shall engage in any act or conduct which is unfair, unconscionable, improper or unlawful. However, the practices of unethical conduct and unscrupulous behaviour in the industry continue. Unethical and unscrupulous tactics have been demonstrated to have been used in the past within the industry to obtain such things as work without payment or work at a reduced cost. These practices include refusing to pay on time, wrongfully disputing that work has been completed satisfactorily, using the threat of no further work unless current work is completed, contriving to invent a dispute in order not to pay and illegal cancellation of cheques after payment has supposedly been made. Further, the industry has allowed re-entry into the industry of participants with a previous record of unethical or unscrupulous behaviour. **However, if there is a breach of trust, there are various remedies against the trustee personally for such a breach. Trust deeds usually provide that a trustee can obtain indemnity for any liability under the trust, although the liability of the trustee arising from fraud or mala fides against the beneficiaries would mean that such an indemnity would not be available. The imposition of rigorous penalties for breaches of trust (ie those arising from unethical or unscrupulous conduct) may, however, curb such conduct considerably.**

(emphasis added)

The Inquiry's response

Broad agreement subject to the detail in the Inquiry's Report.

4.9.7 Acting as a trustee is an onerous position and the nature of the obligations that go with the position are complex. Therefore significant care and due diligence would need to be exercised by trustees to ensure that the trust requirements are met at all times. Can this be achieved?

The trustee has a fiduciary obligation to the beneficiaries of the trust. The obligations imposed on the trustee are complex and onerous. Therefore, the trustee must exercise significant due diligence and care to ensure that all trust requirements were met accordingly. The trustee has both specific and discretionary powers and his actions are governed by the respective State Trustee Acts and common law. The obligations of a trustee in the Building and Construction Industry are no different to that of any other industry. Proper education of those players in the Building and Construction Industry as to the obligations of trustees should ensure that trust requirements are met. Of course, this will be dependent upon the structure of the trust. An independent trustee such as a Government agency or indeed experienced large Head Contractor or Subcontractor, will have available to them the best advice. Accordingly, they will be aware of the obligations of a trustee. It is the smaller Head Contractor and Subcontractor who may be unaware of trust obligations and requirements. As such education requirements at an early instance, perhaps at Trade School, would assist.

The Inquiry's response

This is irrelevant. The main duty of the head contractor trustee is to pay the subcontractor and clear the account until the next payment from the principal.

4.9.8 Operating cash flows through trust arrangements does not recognise the commercial reality of the building industry where projects often run concurrently and cash flows are pooled, not separated on a project by project basis. Can the use of trusts overcome this?

The use of trusts may be able to overcome some of the problems created as a result of this practise through the doctrine of tracing. However, their effectiveness will also be dependent upon whether proper administrative and accounting procedures have been put into place to identify funds that have been pooled. To a large extent, the answer to this issue will depend on the structure of the trust used. As previously mentioned, if monies are mingled with the trustee's

general account they may become unidentifiable. Accordingly, tracing those monies may not be possible. The principle in *Clayton's case* attempts to redress the problem of pooling cash flows, but only succeeds to a limited extent. The rule in this case is that each beneficiary is entitled to a return according to when the money that they were entitled to receive was placed into the trust account. This is not the most ideal situation and the principle is harsh towards those beneficiaries whose monies were placed into the account last and there are insufficient funds to pay these beneficiaries.

The Inquiry's response

Cash flows are not pooled under the Inquiry's proposal.

4.9.9 Is there to be a separate trust arrangement between the Head Contractor and each Subcontractor (and possibly Sub-Subcontractor) or is it envisaged that each project be operated by a separate trust arrangement?

The most effective means of protecting and improving the Subcontractor's security of payment would be to have a separate trust arrangement between the Head Contractor and each Subcontractor. However, the most effective means of implementing a trust mechanism would be to operate each project by one all encompassing trust arrangement, which would encompass the trustee and all beneficiaries. This form of trust arrangement would be less administratively burdensome and cumbersome than the former arrangement. Commercially, the greater single pool of funds that would be created through the latter trust arrangement would probably increase the risk of illegal dissipation of funds and accordingly, a breach of trust.

The Inquiry's response

The Inquiry disagrees. A single payment at the level of contractor and subcontractor and a completely separate trust at the next level is plainly not more cumbersome than an “*all encompassing trust arrangement.*”

4.9.10 Would such arrangements apply to all classes of Subcontractors or only those Subcontractors who have the characteristics of employees?

The answer to this question is really a policy decision. Generally speaking, there is no restriction on who can be a beneficiary of a trust. There is no legal or commercial reason to prevent splitting or combining beneficiaries into classes such as Subcontractors in general on the one hand and Subcontractors having characteristics of employees on the other.

The Inquiry's response

To all classes of subcontractors.

4.9.11 Would a large administrative burden arise for the parties in setting up, monitoring, administering and closing trusts?

The use of trusts from an administrative view point is both burdensome and cumbersome. There is a substantial investment in time needed by the trustee to set up the appropriate procedures to monitor and administer the trust and its practices. Whether there was a large administrative burden would be dependent upon the terms of the trust and the actual obligations imposed on the trustee. The introduction of a formal written trust would require a trust deed to be prepared which can be lengthy, complicated and expensive in its preparation. However, where there are standard building contracts, trust terms could be implemented simply into those building contracts rather than the need to have individual trust deeds. As a general rule, a trustee must not delegate powers and duties attached to the trust. However, the trustee may employ agents to carry out trust responsibilities. The trustee responsibilities are generally onerous. There are accounting and taxation reporting provisions required for trusts which are complicated. Whether or not those accounting and taxation requirements can be made less onerous is a policy issue as to what the level of reporting requirements are to be. Closing the trust, once its usefulness has passed, is also administratively burdensome and cumbersome.

The Inquiry's response

The Inquiry disagrees. There is no trust deed. After the overall trust account is set up nothing more is done. There is no additional accounting and taxation reporting. The trust is not “closed.” The trust bank account remains open to receive all payments from the principal.

Summary

It can be seen from the Inquiry's comments on the 1996 Price Waterhouse answers, in particular, in relation to the only criticism of the trust in that Report set out in the extract of paragraph 4.9.11 above⁴¹⁷, that the Inquiry has now answered and removed the basis for the Price Waterhouse criticisms. This leaves the Price Waterhouse Report, read together with the Inquiry's comments, as perhaps the most thorough supporting analysis for the establishment of a statutory construction trust after the closely reasoned report of the Law Reform Commission of Western Australia.

⁴¹⁷1996 Price Waterhouse Report, p. 53, para 4.9.11.

The Coopers and Lybrand Report

In August 1996, Coopers and Lybrand Consultants, Deacons, Graham and James prepared a report for the NSW Department of Public Works and Services entitled “Independent assessment of the viability of the NSW Security of Payment Committee Proposal” (“the Coopers and Lybrand Report”).

In assessing the viability of the SOPC Proposal, the Coopers and Lybrand Report also had available to it, the previous reports and opinions which considered the SOPC Proposal including the:

- 1994 Andersen Report;
- SOPC response to the Andersen Report which “provided a line-by-line response rejecting much of the reasoning and many of the conclusions of the Andersen Consulting Report”⁴¹⁸;
- review of the SOPC Proposal by Philip Davenport, Solicitor; and
- review of the SOPC Proposal by Roger Gyles, future Royal Commissioner into the Building Industry.

In summarising the review of Roger Gyles QC, the Coopers and Lybrand Report stated:

“In his review prepared in April 1996, RV Gyles, QC restricts his comment on the constitutional validity of the proposal and does not deal with all the legal and practical ramifications of the complete SOPC proposal. Gyles comments on two issues:

- a) the trust concept*
- b) the constitutional validity of the proposal*

He advises that:

- *the trust concept as a basic principle is sound, but “a policy question as to whether administration of the proposed scheme would not be improved by an obligation to keep monies fixed with the trust in a separate account of the type kept by solicitors, real estate agents and so on”. In other words each trustee would have to keep at least two accounts namely for general trading and a trust account.*
- *Constitutional issues relating to bankruptcy and corporations law would not invalidate the scheme”⁴¹⁹*

⁴¹⁸ Coopers and Lybrand Report, p. 16.

⁴¹⁹ Coopers and Lybrand Report, p. 18.

Summarising the SOPC Proposal and response to it at that time, the Coopers and Lybrand Report went on to provide its own independent comments on the viability of the proposal.

The opening section on the Coopers Lybrand/Deacons James Report

In concluding that “*the SOPC proposal is not viable*”⁴²⁰ and that “*in its form and in isolation would not be an effective solution to achieving the SOPC’s stated aims*”⁴²¹, the Coopers and Lybrand Report lists the following reasons in support:

- *“the proposal is at odds with the commercial reality of the industry*
- *significant legal difficulties in achieving protection of monies...*
- *the existing legal system can already provide a range of remedies and sanctions for unethical behaviour*
- *industry specific legislation creating difficulties in the recovery process, adding to costs of recovery and time*
- *the complexity and cost the deemed trust will bring to the industry.*”⁴²²

From the Inquiry’s analysis of the Coopers and Lybrand Report, in particular, its comments and reasoning as to the viability of the SOPA proposal, the following points arise:

- 1) The report seems to implicitly suggest that there is really no problem significant enough to warrant the introduction of the SOPC trust proposal (or for that matter, it would seem any kind of proposed trust legislation). See for example, the following statements which pepper the report:

“The viability of this proposal must be considered in light of the benefit to the industry participants that this initiative will give against the cost.

*The incidence where monies are misused or diverted and which result in a loss being sustained by claimants to those monies are not considered significant in the context of the total industry activity. However, it is recognised that losses have and continue to be suffered by participants in the industry where one of the participants, at whatever level in the supply chain, incurs a loss which it cannot sustain within its own financial resources. The potential result is that suppliers to the participant do not receive full (if any) payment for the debt...”*⁴²³

⁴²⁰ Ibid, p.5.

⁴²¹ Ibid, p.6.

⁴²² Ibid, p.5.

⁴²³ Ibid, p.20.

And:

“At best, the proposal will only provide additional incentive to incentives already in place for participants to act in a proper and commercial manner in their dealings with other participants in the industry in relation to the payment for goods and services rendered. There are too many other factors that operate within the industry which will result in monies not being received in particular circumstances by the rightful recipients. Nothing in this proposal will alter that situation.”⁴²⁴

Yet, it is later suggested that:

“...more significant changes in culture are possible than by attempts to strongly regulate the industry.

An example of an appropriate driver might be when an industry rating scheme was established to rate capability, professionalism, risk, expertise and experience. If the rating system was used by the insurance and financial services industries to differentiate premiums and the cost of funds, as well as government to award work then there would be a strong driver for organisations to improve their performance.”⁴²⁵

- 2) The report goes out of its way to emphasise that trusts “*may be difficult*”⁴²⁶, “*uncertainty may be caused*”⁴²⁷, and may have the “*potential for adding additional complexities*”⁴²⁸ concluding that “*...the cost and time that will need to be spent to resolve the detailed issues we have raised is very difficult to justify in light of the uncertainty of the benefit of that the proposal will bring.*”⁴²⁹
- 3) The report does not contain any legislative recommendations. It states:

“The legislation to bring in affect (sic) the proposal will potentially be very complex and will need to be drafted with consideration to a number of other federal and state acts and laws which are currently in existence. For example, the Corporations Law, Bankruptcy Act.

The legislation to implement this proposal may give cause for more litigation arising from disputes caused through the desire of

⁴²⁴ Ibid, p.30.

⁴²⁵ Ibid, p.33.

⁴²⁶ Ibid, p. 5.

⁴²⁷ Ibid, p. 22.

⁴²⁸ Ibid, p. 24.

⁴²⁹ Ibid, p.28.

*participants to exercise the rights envisaged to be given to them under the legislation. As with any new piece of legislation, litigation is the way to establish how that legislation will be interpreted in many different circumstances to which it may be applied. The likely result of this is that more costs will be incurred by industry participants in dealing with issues arising from the creation of this legislation. To impose by legislation terms of relationship between parties which have always been based on contractual and general commercial arrangements is unlikely to have any real effect unless the capacity to enforce the rights and the penalties associated therein are sufficiently strong.*⁴³⁰

4) The report incorrectly concludes that:

“Relevant existing sanctions include:

- *Trade Practices Act: those sections relating to misleading and deceptive and unconscionable conduct.*
- *Corporations Law: sections dealing within insolvent trading.*
- *The Oaths Act.*
- *Common law deceit and fraud.*

Existing remedies in place include:

- *for government construction agencies to liaise with the relevant state and federal Departments in order to “police” existing legal sanctions.*⁴³¹

The Inquiry’s response

As the Inquiry reads of the recent collapse of Southern Cross Constructions (NSW) Pty Ltd and its effect upon subcontractors, it is difficult to comprehend that at any time statements of the kind set out immediately above could have been made. The statements are wrong. The principles which have been referred to in the statements have nothing whatever to do with the problems in the industry as identified by this present Inquiry’s Terms of Reference. The references to the Trade Practices Act are simply misguided.

The problems with which this Inquiry and other inquiries including the Cole Royal Commission and the Gyles Royal Commission have dealt with have nothing whatever to deal with misleading and deceptive conduct, nor anything to do with the statutory

⁴³⁰ Ibid, p.29.

⁴³¹ Ibid, p.6.

definition of unconscionable conduct. The Oaths Act is a mere side wind and has never been put forward by any commentator as being a solution to the problem of a payment being made by an owner to a builder who goes into insolvency without paying its subcontractors. One might suppose that when a subcontractor learned of its builder's insolvency it might give rise to an oath but not the kind of oath referred to in the Oaths Act. As to common law deceit and fraud, to suggest that those are remedies available to a subcontractor in the situation under analysis is, to be polite about the matter, misguided.

Likewise the reference to "existing remedies" surely must have been made by the author tongue in cheek. To suggest that Government construction agencies liaise with relevant State and Federal Departments in order to "police" existing legal sanctions merely beats the air and would bring a wry smile to the author of the Terms of Reference which established this Inquiry.

Coopers and Lybrand Report's comments on the viability of the SOPC Proposal

The relevant comments extracted from the Coopers and Lybrand Report relating to the viability of the SOPC Proposal are set out below, indented and in italics. For each comment, "the Inquiry's Response" is provided.

*The SOPC proposal directly addresses the symptoms and not the cause of the security of payment problem, and the proposal will not ensure that all subcontractors and suppliers will get paid. At best it will provide as a consequence of penalties a strong incentive for people to meet their obligations.*⁴³²

The Inquiry's response

The Inquiry agrees with the first part of the first sentence which is really to say that the root cause of the problem will be addressed by the Inquiry's recommendations concerning the establishment of the NSW Building and Construction Commission and the licencing and capital backing programme.

The Inquiry agrees with the second sentence.

*"Existing legislation such as the Bankruptcy Act, Corporations Law and the Oaths Act could be reviewed to achieve a similar effect".*⁴³³

⁴³² Ibid, p. 4.

⁴³³ Ibid.

The Inquiry's response

There is no comfort to be had in an examination of the Bankruptcy Act, Corporations Law and the Oaths Act. This would be a waste of time.

“The SOPC proposal is not viable due to:

- *the proposal is at odds with the commercial reality of the industry*
- *significant legal difficulties in achieving protection of monies (refer legal difficulties below)*
- *the existing legal system can already provide a range of remedies and sanctions for unethical behaviour*
- *industry specific legislation creating difficulties in the recovery process, adding to costs of recovery and time*
- *the complexity and cost the deemed trust will bring to the industry.*⁴³⁴

The Inquiry's response

Each of these unsupported generalities has been dealt with in the Inquiry's comments upon the Andersen Report. The Coopers and Lybrand Report simply recycles most of those comments and there is no point in adding further to the analysis of the Andersen Report.

“The legal difficulties are in the three main areas:

1. *The requirement for federal legislation in relation to:*

- *Bankruptcy Act: changing the statutory order of priority of creditors so that interest of contractors, subcontractors and suppliers takes priority over other creditors.*
- *Corporation Law: that directors acting in “Good Faith” may in many circumstances invalidate any sanctions for violation of the scheme.*
- *Trustee Acts: that existing trustees acting “honestly and reasonably” may in many circumstances invalidate sanctions for violation of the scheme.*⁴³⁵

The Inquiry's response

The statutory order of priorities is not going to be changed. The trust operates to ensure that no question of the statutory priorities arises because the statutory priorities relate to the competition between creditors for a share of the bankrupt estate or the assets of the

⁴³⁴ Ibid, p. 5.

⁴³⁵ Ibid, p. 5.

company in liquidation. The precise purpose of the trust mechanism is to ensure that the trust proceeds are never included in the bankrupt's estate or the assets of the company in liquidation. It is precisely the same for the assets of the company in an insolvency.

The point made by the directors' acting in good faith is nonsense. Any director who pays away money out of the trust fund other than for the purposes of paying the subcontractors will find it difficult if not impossible to demonstrate that the payment was in good faith. Particularly if the trust account is segregated and entitled in accordance with the Inquiry's recommendations.

Even if a trustee were able to make out the defence of acting "honestly and reasonably" why should that be a valid criticism of the trust concept? If the law establishes existing defences and if they could be made out, then it hardly seems to strike against the concept of the trust itself.

*"2. trusts may be difficult to implement due to the complex relationships being created with no guarantee that such complexity will ensure security of payment to all members in the construction chain."*⁴³⁶

The Inquiry's response

Once again one finds general assertions concerning a "complex relationship". A relationship in which the head contractor holds funds on trust when it is being paid by the principal in respect of work carried out by a subcontractor does not seem to be one of undue complexity.

There can never be a *guarantee* that all members in the construction chain will be paid. As has been emphasised on a number of occasions in this Report, all will depend upon the amount of money paid into the trust fund by the principal and upon the way in which SOPA resolves competing claims.

*"3. commercial uncertainty is created by imposing trust law over contract law, which will lead to significant potential for increased levels of disputation."*⁴³⁷

⁴³⁶ Ibid.

⁴³⁷ Ibid, p. 5.

The Inquiry's response

This is an almost meaningless assertion which is difficult to engage for that reason. The trust does not seem to have presented problems in Canada since 1932 nor in the United States where the trust is enacted in many states.

“Legal Issues

The legal issues, both in terms of creating the legislation and its subsequent operation have the potential to be very complex.”⁴³⁸

The Inquiry's response

This assertion is unsupported. It is true that any proposed legislative amendments have the potential to be complex. The key word is “potential”. That can be left in the safe hands of the Parliamentary Counsel to draft. There will no doubt be cases which arise solely from the novelty of the proposal and the fact that those who are affected by it will take some time to adjust to it. In the present case the Inquiry has recommended a two year transitional period. Nevertheless where complexities do become apparent in connection with a particular legislation amendment the draftsman has the capacity, tabula rasa, to anticipate and deal with some of those complexities. That is the case here. The Inquiry has drafted a number of suggested ancillary sections to dispel some of the complexity and to make operation of the statutory trust a smoother experience for those who are affected by it.

A judgement may be made upon an examination of the terms of the recommended legislation.

The repeated generalisation about the operation having “the potential to be very complex” is unsupported and unhelpful.

“Philip Davenport stated that federal legislation, in particular the Corporations Law and Bankruptcy Acts, will require amendment to ensure the priority claim to monies. This may be the case, as the proposal seeks to remove the “trust monies” from the control of the liquidator, therefore precautions will be irrelevant.”⁴³⁹

The Inquiry's response

No amendment to any federal legislation is required, not the Corporations Act nor the Bankruptcy Act. The expression “*priority claim to monies*” is an incorrect

⁴³⁸ Ibid, p. 21.

⁴³⁹ Ibid, p. 21.

characterisation. No moneys “are removed” from the control of the liquidator. The trust moneys do not ever fall under the control of the liquidator for the simple reason that they are from the point of inception, from the point of payment, always trust moneys and for that reason no question of altering priorities or removing “trust moneys” from the control of the liquidator arises. The expression “therefore precautions will be irrelevant” is mystifying.

No federal legislation requires amendment “to ensure the priority claim to moneys.”

“However, amendment may be necessary to ensure that the trust proposal seeks to give relevant claimants is enforceable without question against all other creditors, for example in cross border issues. It is our view that to be effective, Federal Government support is necessary.”⁴⁴⁰

The Inquiry’s response

For the same reasons which have been expressed in relation to the immediately preceding paragraph this paragraph is simply wrong from a legal point of view. Once the trust has been established that is an end of the matter. The cross border issues effectively disposed of by what was said by the Western Australian Law Reform Commission, and in the view of the Inquiry the answer given there was with respect, accurate and dispositive.

“Complex legal issues will also need to be considered when formulating the legislation which would give effect to the SOPC proposal. There is clearly uncertainty as to the full legal integrity and practicality of this aspect of the proposal. The time and costs that would be incurred in thoroughly investigating and resolving (if possible) all possible legal issues, may be difficult to justify given the uncertainty as to the ultimate benefit of the trusts as an effective mechanism to secure payment to all participants within the construction industry.”⁴⁴¹

The Inquiry’s response

This particular paragraph contains considerable obfuscation. It is vague and general and in any event falsely describes the aim of the trust as “an effective mechanism to secure payment to all participants within the construction industry”, a goal worthy of Rumpelstiltskin. Such a goal would be the holy grail of any industry but let it be restated, the aim of the construction trust is to protect those payments which have been made by a head contractor and not passed on by the head contractor to the subcontractor

⁴⁴⁰ Ibid.

⁴⁴¹ Ibid, p. 21.

in circumstances where insolvency intervenes. A trust cannot do anymore than impress itself upon those payments which have been made.

None of these general propositions are supported. Some of them are unclear.

As to the “.....*uncertainty as to the ultimate benefits of the trust as an effective mechanism...*” the trust can be guaranteed to protect a payment to be made by a principal to a head contractor which includes subcontractor payments in the event that the head contractor does not pass those payments onto the subcontractors and goes into insolvency.

As to the last part of the Coopers and Lybrand comment the trust has never been touted as a solution “... *to secure payment to all participants within the construction industry*”.

“The practical application of the SOPC proposal when a breach occurs raises some specific legal issues which the proposed legislation would need to address such as:

- *What money is trust money? That is, with numerous payments being made into a trade account as opposed to a separate trust account, there will be a need to identify trust monies. Costs may be involved in the tracing exercise which is inherent in the operation of trust laws.*⁴⁴²

The Inquiry's response

This so called difficulty can be disposed of briefly. There will be a separate trust account and so the question simply does not arise. In any event the answer to the question “what money is trust money” is any money paid which meets the description in the statutory section. That is money paid in any respect of work carried out and material supplied by subcontractors.

The assumption is correct. The account is not a trade account, it is a trust account.

What money is trust money? All moneys paid by a principal to a head contractor which include payment for work carried out and materials supplied by a subcontractor.

Identification of the trust money is achieved simply by matching the money up against the statutory description.

⁴⁴² Ibid.

“Which party in the supply chain is entitled to the trust money? That is, in the event that a claim may be short paid, who will be entitled to the money from that claim if there are more than one claimant.”⁴⁴³

The Inquiry’s response

Where a claim is short paid then under the Inquiry proposal the first payment that is due to be paid in accordance with the statutory payment obligation will be paid. If the fund is exhausted then that is the end of the matter save for the fact that subcontractors will continue to have a personal claim against the head contractor. If there is a dispute about whether moneys are due from the principal to the head contractor that will be decided by SOPA. If SOPA decides in favour of the head contractor then additional moneys will be paid into the trust account and paid out accordingly. The trust does not have the capacity to magically create money nor will it deprive the claimant of its entitlement. The question which has been asked by the author of the Andersen Report is precisely what can arise in any event absent the trust. The trust does not bring about the circumstance in which short payment causes difficulties.

This is an echo of some of the discredited material in the Andersen Report.

The answer to the first question, is the subcontractors. The subcontractors will be paid in accordance with the statutory recommendation in the order in which their claims were received bearing in mind that the head contractor will be obliged to pay the first one of them which has been due and payable for 28 days.

Analysts of the trust concept should need no reminding that whatever is in the trust account can only have been placed there by means of a payment of a claim by principal to the head contractor. If the funds in the trust account are inadequate because the principal has short paid then the matter may be traced through as follows:

- i) If the short payment arises because of the impecuniosity of the owner.
- ii) If the short payment arises because of a dispute between the owner and the head contractor that dispute is resolved through SOPA.
- iii) If the head contractor has certified that these moneys are owing to the subcontractor then it will not be heard to dispute its liability to pay the subcontractor and if there is a problem between the head contractor and the principal in that regard then that is a matter to be sorted out through SOPA.
- iv) If after those mechanisms have been worked through and there are let it be supposed, two out of four subcontractors who cannot be paid in full

⁴⁴³ Ibid. p. 22.

out of what is left in the trust account then they will be paid at that stage rateably and they will have their action under SOPA against the head contractor for the remainder.

“The precise point in time when the trust crystallises. That is, in the case of a bankruptcy, each sub-contractor will need to identify when their claim was lodged and to what extent is it going to get priority over another trust claim.”⁴⁴⁴

The Inquiry’s response

This is nonsense. The trust crystallises the moment money is paid by the principal to the head contractor into the trust account. Each subcontractor does not have to identify when their claim was lodged in the case of bankruptcy “in order to get priority over another trust claim.”

This is a misguided view of events and may be disregarded. Once the trust has crystallised then there is never any question of the moneys being contested within a bankruptcy and of identifying when the particular claim was lodged.

The rest of this point is irrelevant. There is no need for any subcontractor to identify anything in the case of bankruptcy or insolvency in order to get priority. The writer of this particular point does not seem to understand the difference between a trust fund which never finds its way into bankruptcy or insolvency contention and an account which does. The purpose of the statutory trust is to place the moneys in the first category.

“Where monies are held and a third party such as a contractor from another contract is seeking to claim funds held in the combined account of the contractor. How will this be provided for?”⁴⁴⁵

The Inquiry’s response

This question beats the air. It does not arise in the case of a separate segregated trust account. The funds that are claimed will not be held in the combined account of the contractor.

Once again this shows a significant misapprehension about the nature of the trust and the trust account. There is no combined account. The purpose of the segregated and named trust account is to avoid those sorts of difficulties.

⁴⁴⁴ Ibid, p. 22.

⁴⁴⁵ Ibid, p. 22.

“This could be the case where a contractor may need to utilise trust monies to pay a critical subcontractor to ensure the project continues for the benefit of all parties who have an interest in that project.”⁴⁴⁶

The Inquiry’s response

All moneys remain within the project pyramid. Moneys are paid out of the trust account in accordance with the statutory priority. That means if a particular subcontractor had his progress claim in to the head contractor before another then the 28 day obligation to pay will crystallise in relation to the first of those subcontractors before the second and so on.

In the case where a principal pays all of the moneys that are the subject of the progress payment claims made by the head contractor then some or all of those moneys will be used to pay the subcontractors. If there is a need to dip into the notional share in the trust fund due and payable to the head contractor in order to pay a subcontractor whose claim has been certified or agreed by the head contractor then so be it. The first obligation of the contractor is to pay the subcontractors.

This is an oxymoron. If the contractor is entitled to trust moneys from the account in order to pay a critical subcontractor to ensure the project continues, the subcontractor has ex hypothesi a right to its share of the fund.

This is so because of the need to adopt an even handed attitude between beneficiaries and at the same time to follow the statutory prescription that the “critical subcontractor” will have to wait his turn in the payment scheme of things.

The question ignores the fact that the head contractor can always discharge his contractual obligations to the subcontractor by paying the subcontractor out of the head contractor’s funds.

There is no induced paralysis brought about by anything associated with the introduction of the trust.

“Uncertainty may be caused by the application of the law of trusts to the law of contract. The contract chain has as its central philosophy the objectives of keeping parties to a contract at arm’s length and a trustee will have to avoid conflict between its own commercial interests on one hand and its duty to trust beneficiaries on the other.”⁴⁴⁷

⁴⁴⁶ Ibid, p.22.

⁴⁴⁷ Ibid, p. 22.

The Inquiry's response

Of course. This is a virtue of the trust not a reason for criticising it.

The rule is correctly stated. A trustee is required to avoid conflict between its own commercial interests on one hand and its duty to trust beneficiaries on the other.⁴⁴⁸ That rule is reflected in and embraced by the Inquiry's recommendations. One of the Inquiry's recommendations in fact is that the contractor is not allowed to pay itself unless and until all subcontractors have been paid.

The effectiveness of this feature of the statutory construction trust is appraised by Ettinger who states:

"Once the owner has paid the contract price, the only mechanism to ensure that the funds stay within the construction chain is the trust. Once money is paid on the contract to the contractor or a subcontractor, he may not appropriate any of those funds to his own use until such time as he has paid in full all those with whom he has contractual privity."⁴⁴⁹

The Coopers Lybrand Report then goes on to say:

"To ensure that the proposed legislation would deal with these very practical issues in a proper manner will, in our opinion, be very difficult. The aim would be to ensure that the legislation is sufficiently comprehensive to minimise the potential for relevant parties to litigate over the application and enforcement of the legislation in circumstances where breaches have occurred. This in itself will not prevent costs being incurred in parties challenging and seeking court interpretation of the effectiveness of the proposed legislation."⁴⁵⁰

The Inquiry's response

Neither the Inquiry nor any legislative draftsman can give a guarantee that those who are in dispute over entitlement to money will not chance their arm. Any claim to absolve or inoculate any law reform initiative from litigious challenge would be foolish.

Any legal action is expensive. There is really little else that needs to be said.

"Conclusion (legal)

⁴⁴⁸ *Keech v Sandford* [1726] Sel.Cas. Ch. 61.

⁴⁴⁹ Ettinger, L. P., "Trusts in the Construction Industry" (1988-1989) 27(3) *Alberta Law Review* 390 at 425.

⁴⁵⁰ *Ibid*, p. 22.

Accordingly, given the extent of legal difficulties, both in a legislative and practical sense and the potential benefit to the industry of such legislation, it does in our view raise serious questions about the overall viability of the core aspect of the SOPC proposal. The SOPC response to the Andersen report acknowledges that the deeming trust proposal will not guarantee payment to participants but rather, will offer a greater incentive for the participants to deal with monies in the appropriate manner.”⁴⁵¹

The Inquiry’s response

The rather facile proposition that “...*the deeming trust proposal will not guarantee payment to participants...*” is hardly worth dealing with. No adherent of the trust proposal has ever suggested that it has the magical capacity to create money. Neither the SOPC nor any other proponent of the statutory trust has called in the services of Rapunzel.

“*The extent of the legal difficulties*” has never been pointed out in any detail.

Reliance upon the SOPC response to the Andersen Report which “*acknowledges that the deeming trust proposal will not guarantee payment to participants...*” is a rather disingenuous proposition. No proponent of the trust has ever suggested that it would “guarantee payment to participants”. All that can be claimed for the trust, and this important claim has not been refuted, is *that it will protect those payments that have been made by a principal to a head contractor and not passed on before the head contractor’s insolvency.*

“The proposal with all the potential legal difficulties is not practical. Moreover, there already exists in legislation such as Corporations Law, Trade Practices Act and the Oaths Act, incentives for proper behaviour in commercial relationships. These may be strengthening or be “policed” more effectively. This would be easier and achieve the same result as the SOPC proposal.”⁴⁵²

The Inquiry’s response

The conclusion does not follow from the vague assertion which preceded it.

This is a particularly weak section of the report which is really little more than wishful thinking. The “incentives for proper behaviour in commercial relationships” are not what was intended to be dealt with by the trust. The trust is designed to reduce the effects of a builder’s insolvency.

⁴⁵¹ Ibid, p. 23.

⁴⁵² Ibid, p. 23.

“In relation to the Andersen report on the legal viability, we note that their assessment is quite detailed and specific. A number of their comments were challenged by the SOPC Committee in their response. In both instances, we can identify merits and weaknesses in the respective approaches taken.”⁴⁵³

The Inquiry’s response

No response is called for.

The Inquiry takes issue with the description of the Andersen Report as an “assessment (which) is quite detailed and specific”.

“Benefit/Cost

The incidence where monies are misused or diverted and which result in a loss being sustained by claimants to those monies are not considered significant in the context of the total industry activity.”⁴⁵⁴

The Inquiry’s response

This contention by the author of the Coopers and Lybrand Report stands in complete contradiction to the vast body of evidence given to the Gyles Royal Commission, the Cole Royal Commission and numerous other inquiries, and all of the facts and evidence put before this Inquiry. It may be rejected.

Before leaving the subject, a comment should be made about the rather offhand reference to the claims not being “considered significant”. One might pause for a moment to enquire whether that is a true reflection of the views of the countless subcontractors who make up the yeoman force in the industry who have lost significant amounts of moneys. The comment is wrong and it may be entirely disregarded.

“However, it is recognised that losses have and continue to be suffered by participants in the industry where one of the participants, at whatever level in the supply chain, incurs a loss which it cannot sustain within its own financial resources. The potential result is that suppliers to the participant do not receive full (if any) payment for the debt. The reason for losses being suffered are many, including lack of adequate capital, financial management, poor job costing and external factors.”⁴⁵⁵

⁴⁵³ Ibid.

⁴⁵⁴ Ibid, p. 20.

⁴⁵⁵ Ibid, p. 20

The Inquiry's response

This paragraph in the Coopers and Lybrand Report is a little closer to reality and the Inquiry notes that a considerable amount of evidence given to the Inquiry was along these lines. Nevertheless there is no basis for concluding that the knock-on effect of head contractors not paying subcontractors was not a contributing factor to hardship, loss and ultimately insolvency. The problem that this Inquiry has faced⁴⁵⁶ is that in order to ascertain exactly how many subcontractors have experienced a combination of external circumstances one of which was the failure by head contractors to pay, have gone into insolvency as a result would require the conduct of prohibitively expensive surveys and other investigations.

The Inquiry agrees on the basis of the evidence it has heard.

“The SOPC proposal does not seek to address any of these issues. The capacity to successfully achieve the stated aims of the proposal being to secure payment or prevent monies from misuse is far from certain if the proposal is enacted. It is our view that the SOPC views which were expressed in their initial proposal and in the response to the Andersen report, that the deeming trusts is not a legally complicated initiative is a simplistic assessment.”⁴⁵⁷

The Inquiry's response

The issues which the SOPC proposal stand accused of not addressing ie. those in paragraphs 1 and 2 of the Andersen Report are not really issues that require addressing at all. Nothing is certain in this life but one thing that can enjoy a rather confident view is that the deemed trust will substantially reduce the losses to subcontractors caused by head contractors' insolvency.

The Coopers and Lybrand Report does not deal with nor dispose of the carefully considered and expressed advantages of the trust system which are set out earlier in this section of the Report.

“Commercial issues

The commercial relationships which have been established and exist between the participants in the construction industry operate reasonably effectively. The majority of participants would seem to have good commercial relationships. The terms of the relationship between participants will vary from contract to contract and will be impacted upon by a number of factors, contractual,

⁴⁵⁶In common with other inquiries.

⁴⁵⁷Ibid, pp. 20-21.

*legislative and commercial. The SOPC proposal aims to impose by legislation a certain factor in the relationship between the participants in the industry. There is the potential for this proposal to add a further complication to the commercial relationships which may then give rise to more causes for dispute between participants.*⁴⁵⁸

The Inquiry's response

The first sentence is simply wrong, is not supported by any evidence and is contrary to a vast body of evidence given to numerous inquiries. It does not rise above mere assertion. Coopers and Lybrand seem to be analysing a part of the industry which bears no relationship to the evidence given to this and numerous other inquiries.

*“The Andersen report highlighted a number of economic/commercial impacts of the proposal. These included potential for increased costs in the industry. Adverse impact upon how financiers will view projects or financing participants in the industry.”*⁴⁵⁹

The Inquiry's response

There is an element in this paragraph that does require some careful analysis and that is the adverse effect upon how financiers will view projects or financing participants in the industry. This question has been dealt with in detail in another section of this Report.

The SOPC in its response rejected the findings of the Andersen Report largely for the reason that they considered it had either misinterpreted the operations of the proposed scheme or were utilising incorrect data in supporting their conclusions.⁴⁶⁰

This is dealt with separately in this Report.

There is no evidence of how financiers will view projects or financing participants in the industry adversely. Nor is there any reason in principle why they should do so.

*“In our view, the perceived simplicity of the deemed trust proposal is, in a commercial sense, too simplistic. We see the proposal of deeming trusts as providing the potential for adding additional complexities to the commercial relationship between participants in the industry, and for little real or certain benefit.”*⁴⁶¹

⁴⁵⁸ Ibid, p. 23.

⁴⁵⁹ Ibid, p. 24.

⁴⁶⁰ Coopers and Lybrand Report, p. 24.

⁴⁶¹ Ibid, p.24.

The Inquiry's response

Perhaps the subcontractors who have never been paid ought to be asked whether there are “little real or certain benefits”.

The “real” benefit is that these moneys including retention sums will not be lost in insolvency. The “benefit” is certain because no respectable legal analysis has called into question the legal efficacy of the trust.

This is an assertion without any evidence.

“It is worthwhile taking initiatives which are designed to address the current deficiencies that exist within the industry and its culture but these solutions generally are not successful if they are based on a legislative initiative to impose upon all participants the manner in which they are to transact business between each other.”⁴⁶²

The Inquiry's response

This is simply to say that any legislative initiative should take into account the detailed views of those who are likely to be affected by it and endeavour to address their concerns. That is the way in which the Inquiry has approached its task.

“It is our view that the benefits of the trust proposal will be hard to achieve when it will be relied upon by a participant. This is best illustrated as follows:

Insolvency scenario

Facts:

- *Head contractor (HC) has 4 contracts in progress and is awaiting final payment on 3 completed contracts.*
- *HC has engaged 20 sub-contractors on 4 contracts. Sub-contractors have 100 suppliers who they owe money to in relation to the contracts.*
- *HC has 30 non-contract related creditors such as landlord, bank, utilities and employees.*
- *All monies received by HC are banked into one account. All payments are made from this account.*
- *Assets of HC are debtors (unpaid claim), work-in-progress, plant and equipment.*
- *HC is placed into liquidation and liquidator realise all assets. He has \$1m funds to meet, \$5m of liabilities.*

⁴⁶² Ibid.

Currently

Creditors Position

- *The \$1m would be distributed to all direct creditors of head contractor, in accordance with Corporations Law relating to priorities, e.g. Employees of head contractors first (excludes employees who are directors), and then secured and unsecured creditors. Suppliers to sub-contractors have no direct claims to HC.*

Under Trust Proposal

- *Potential for dispute between direct sub-contractor and non contract creditor as to who's money is the \$1m.*
- *Are all sub-contractors and non contract creditors entitled to monies if plant and equipment is purchased by the trust?*
- *Will the 100 suppliers be able to claim against HC? Do suppliers share in funds or make trust claims on monies to step ahead of non-contract and sub-contractor creditors?*
- *A tracing exercise will be required for all 20 sub-contractors and 100 suppliers to identify trust monies.*⁴⁶³

The Inquiry's response

Taking each of the bullet points under the heading "Under Trust Proposal":

As to the first point:

There is no potential for any dispute between a subcontractor and a non contract creditor as to whose money is in the \$1 million. The missing fact in the insolvency scenario is information concerning the payment made by the head contractor in respect of a particular project which includes work carried out by the subcontractors. For this problem to make any sense at all one would need to know in relation to any particular project what progress payment had been made by the principal to the head contractor. Once that was established then there could never be any dispute between a direct subcontractor and a non contract creditor as to whose money is in the \$1 million. The scenario although incorrectly set out is a powerful support for the proposition that the subcontractors do not have to engage in a dispute between themselves and non contract creditors.

As to the second point:

⁴⁶³ *Ibid*, pp. 24-25.

This question can never arise because the trust does not trade. It would never be possible for the trust to purchase plant and equipment. To do so would be a breach of the trust and the question drafted by the author demonstrates a lack of understanding of the nature of the trust and may be dismissed.

As to the third point:

Suppliers are subcontractors and they do share in the trust funds if the payment from the principal to the head contractor includes payment for those suppliers.

As to the fourth point:

The tracing exercise is rendered unnecessary because the trust funds are already identified and the question to whom the money should be paid is answered by the statutory requirement to pay within 28 days and the question what is to be paid is answered either by the certification, the agreement or by SOPA.

“From a practical point of view, the trust proposal will cause significant arguments between claimants to the funds when they seek to rely on the deemed trust. This will not only add to the cost of sorting out the problem, but could cause significant delay in achieving the distribution of the funds.”⁴⁶⁴

The Inquiry’s response

This is a repetition of an earlier theme.

There cannot be arguments between claimants to the fund. The claimant’s entitlement to the fund depends upon the certification or agreement of the head contractor or a SOPA determination. Once that has happened either one or the other of those methods will decide which claimant is entitled to what.

The owner will only be paying that which it is legally required to pay to the head contractor.

“Therefore, from a commercial and practical point of view, when the effect of the deemed trust is most required and its greatest benefit is to be evidenced, the benefit could in fact be lost in meeting the costs of sorting out the many issues.”⁴⁶⁵

The Inquiry’s response

These general assertions have been dealt with earlier.

⁴⁶⁴ Ibid, p. 25.

⁴⁶⁵ Ibid, p. 25.

“Conclusion (commercial)

Our view is that from a commercial point of view, whilst the concept of a deemed trust is theoretically sound and simple to implement, the effect of such a change on the commercial relationships and operations of the industry are unknown. Therefore, the potential to create more problems and the scale of those problems are such that we do not see the benefit outweighing “the potential commercial costs of this initiative.” We see this as going to the very core of the viability of this aspect of the SOPC proposal.”⁴⁶⁶

The Inquiry’s response

The important statement made by Coopers and Lybrand is that the:

“...concept of a deemed trust is theoretically sound and simple to implement...”
(emphasis added)

The Coopers Lybrand Report’s next contention to the effect of such a change on the commercial relationships on the industry is unknown, is hardly a reason not to seek to educate the industry and transition the amendment into law.

“Shortened payment cycle

The SOPC as part of its proposal also recommended that initiatives be taken to shorten the payment cycle between participants within the industry. In particular, the Committee was very concerned at the degree to which sub-contractors are exposed by having an obligation to continue to provide goods and services under its contract without payments being received for work or services provided.”⁴⁶⁷

The Inquiry’s response

Agreed.

“The Andersen report made considerable comment to this issue. In particular it considered that the shortening of the payment cycle could add costs to projects as it removed “free capital” from the cash flow pipeline operating within the industry. It acknowledged that this free capital is largely available to the parties at the head of the supply chain, being head contractors, builders and owners but

⁴⁶⁶ Ibid.

⁴⁶⁷ Ibid, p. 26.

other parties lower down the supply chain could also have access to a reasonable amount of free capital.”⁴⁶⁸

The Inquiry’s response

It is difficult to see how “other parties lower down the supply chain could also have access to a reasonable amount of free capital.”

“The SOPC in their response state that the concept of “free capital” was morally reprehensible. It should be addressed.

It is our view that it is questionable that “free capital” exists. What the current payment cycle of the industry does permit is certain commercial leverage to be applied at various stages which would result in certain participants taking extended credit terms where they are not otherwise provided. In essence, it is not an issue of “free capital”, it is more an issue of which participant or participants will bear the funding costs of the particular project. By funding costs it is not only meant the funding costs that the owner will incur but the costs that each participant incurs in the operation of its own business which it would seek to build in to its pricing on the project. On this basis, the SOPC response is justified.”⁴⁶⁹

The Inquiry’s response

The Inquiry agrees with Coopers Lybrand that:

“...it is more an issue of which participant or participants will bear the funding costs of a particular project. By funding costs it is not only meant the funding costs that the owner will incur but the costs that each participant incurs in the operation of its own business which it would seek to build into its pricing on the project.”

Although Coopers Lybrand agreed with the SOPC response⁴⁷⁰ they ignored the fact that under the present arrangements the true financiers of a project are those subcontractors who wait for long periods without being paid for work and materials supplied.

As Canadian construction lawyer and legal author, Bruce Reynolds puts it:

“In Canada, as elsewhere, the construction industry is not only a vitally important sector of the economy, but, as well, is an industry in which cash-flow

⁴⁶⁸ Ibid.

⁴⁶⁹ Ibid, pp. 26-27.

⁴⁷⁰ With which the Inquiry respectfully agrees.

*is king and many of its lesser participants are not infrequently so thinly capitalised that they are constantly vulnerable to the threat of insolvency. Further, due to the traditional contractual models utilised for construction projects, and in particular payment terms which (understandably) provide for payment in arrears of the actual supply of services and materials, construction in Canada is, in reality, financed in the short term by the sub-contractors and suppliers which deliver services and materials on the strength of their own credit only to see their contributions absorbed into the freehold”.*⁴⁷¹

Next the Coopers and Lybrand Report states that:

*“The terms of the payment cycle as explained by both Andersen and SOPC, in our view causes the greatest pressure on the industry participants particularly those at the lower level of the supply chain. We agree with the Andersen view that the payment cycle issue is a more critical issue in terms of the general efficiency and operation within the industry.”*⁴⁷²

The Inquiry’s response

The Inquiry respectfully agrees with Coopers Lybrand and with Andersen that the payment cycle issue is a more critical issue in terms of the general efficiency and operation within the industry.

*“The principles put forward by the SOPC should be carefully considered and implemented largely through imposing the appropriate conditions in standard contracts. This initiative would in itself lessen the likelihood of funds being misused and redirected. Moreover, it would also contribute to creating an environment where those participants who may be experiencing financial difficulties could be identified on a more timely basis to enable appropriate action to be taken to avoid or minimise the losses suffered.”*⁴⁷³ (emphasis added)

The Inquiry’s response

This particular paragraph acknowledges that a trust fund arrangement to which the parties agreed.

⁴⁷¹ Reynolds, B., “A Canadian Approach to the Minimisation of Construction Insolvencies” at 117.

⁴⁷² Ibid, p. 27.

⁴⁷³ Ibid.

The report seems to be saying that the *same* kind of trust that would be imposed by *statute* would achieve all of the objectives which the Inquiry and the proponents of the statutory trust for which the Inquiry and the proponents of the *statutory* trust contend.

This statement by Coopers Lybrand is a complete embrace of the statutory provision. The Inquiry respectfully agrees with the statement.

“Information rights

Issues such as giving the beneficiary of a trust a right to inspect and obtain information in relation to details of contract, including contract price, state of accounts between owner and contractor and labour and material payments bonds would in our view be difficult to legislate for. It would add considerable complexity to the general commercial relationship that exists between participants. In relation to some legal aspects, the proposal would be against the legal principle of confidentiality of contractual information between parties.”⁴⁷⁴

The Inquiry’s response

This has been dealt with by the Inquiry.

“Secondly, the proposal to extend liability for breaches of the right for information provisions to what could be unrelated parties will be very difficult to legislate properly within the generally accepted principles of contract and law of equity. This will be further complicated when the proposal is seeking to engage the Court in enforcing compliance with the proposed provisions of this part of the proposal.”⁴⁷⁵

The Inquiry’s response

All of this is a simple recycling of the Andersen Report and has been dealt with.

“The aspect in relation to right to information to the extent that it is an integral part of the trust proposal will, in our view, add further complications and we question the ultimate effectiveness.”⁴⁷⁶

The Inquiry’s response

This has been dealt with by the Inquiry.

⁴⁷⁴ Ibid, p. 28

⁴⁷⁵ Ibid.

⁴⁷⁶ Ibid.

“Therefore, the cost and time that will need to be spent to resolve the detailed issues that we have raised is very difficult to justify in light of the uncertainty of the benefit of the proposal will bring.

Summary of comments

The SOPC proposal as stated in their document is not, in our view, a viable proposal. Whilst the proposal seems to provide a simple, easy to implement and effective solution to achieve the aims of ensuring that monies are treated in the appropriate manner within the industry, its viability is very questionable for the following reasons.”⁴⁷⁷ (numbered 1-7 on the following pages)

(1) The legislation to bring in affect (sic) the proposal will potentially be very complex and will need to be drafted with consideration to a number of other federal and state acts and laws which are currently in existence. For example, the Corporations Law, Bankruptcy Act.

The Inquiry’s response

This proposition has been legally discredited.

(2) The legislation to implement this proposal may give cause for more litigation arising from disputes caused through the desire of participants to exercise the rights envisaged to be given to them under the legislation. As with any new piece of legislation litigation is the way to establish how that legislation will be interpreted in the many different circumstances to which it may be applied. The likely result of this is that more costs will be incurred by industry participants in dealing with issues arising from the creation of this legislation. To impose by legislation terms of relationship between parties which have always been based on contractual and general commercial arrangements is unlikely to have any real effect unless the capacity to enforce the rights and the penalties associated therein are sufficiently strong.

The Inquiry’s response

This has been dealt with by the Inquiry.

(3) The proposal seeks to break down aspects to commercial relationships which would, for a number of reasons, be resisted by the participants in the industry. This is particularly in relation to rights to information.

⁴⁷⁷ Ibid, p. 29.

The Inquiry's response

This has been dealt with by the Inquiry.

(4) At best the proposal will only provide an additional incentive to incentives already in place for participants to act in a proper and commercial manner in their dealings with other participants in the industry in relation to the payment for goods and services rendered. There are too many other factors that operate within the industry which will result in monies not being received in particular circumstances by the rightful recipients. Nothing in this proposal will alter that situation.

The Inquiry's response

What does this contention entail? There are too many other factors that operate within the industry which will result in moneys not being received in particular circumstances by the rightful recipients" say Coopers and Lybrand, so let us not bother to remedy one factor which is capable of remedy!

(5) This proposal may also result in making more complex the resolution of the position where insolvency occurs and there are insufficient funds to meet all obligations. It will certainly add to the costs of sorting out the issues.

The Inquiry's response

This has been dealt with by the Inquiry.

(6) The certainty with which the benefits of the SOPC proposal will be enjoyed by the industry is very questionable. Given this, it is hard to justify the incurring of significant costs and creating further potential complexities which this proposal may bring.

The Inquiry's response

This has been dealt with elsewhere in the Report.

(7) The existing legal system does have in it a number of incentives for operators in the industry and in commerce generally to act in a proper and fair manner. Provisions including the duties and responsibilities of directors contained in the Corporations Law, provisions in the Bankruptcy Act in relation to incurring debt without reasonable expectation of being able to pay it as well as various other provisions specific to compliance with industry specific acts could all be enhanced to provide equally as much incentive to the participants in the industry to act with propriety and not misuse or redirect monies.

The Inquiry's response

At the end of that analysis the Coopers and Lybrand Report came up with a list of “Next steps” which were said to “have been developed to improve the culture, professionalism and competitiveness of the industry.”⁴⁷⁸ None of these steps included any statutory recommendations notwithstanding that the first of them calls for increasing penalties for making false or misleading statements in statutory declarations. In the Inquiry’s opinion the primacy of that recommendation and the absence of any suggestions that there should be a legislative amendment place the Coopers and Lybrand Report in its proper setting.

Summary

The adverse conclusions in the Coopers and Lybrand Report should be rejected in their entirety. The report is replete with unsupported assumptions, wild conclusions, speculation and legal error. It misapprehends the true nature of the trust mechanism.

The 1998 Legal Commentary

In August 1998 the Joint Standing Committee upon Small Business prepared a report entitled “*Security of Payment, Deemed Trusts: The Full Debate*”. One of the submissions to that inquiry was from a venerable and distinguished law firm, which had been briefed by the Property Council of Australia (PCA) and the Australian Constructors Association (ACA)⁴⁷⁹ “to comment upon draft amendments to the Contractors Debts Bill relating to the setting up of statutory trusts in the construction industry”⁴⁸⁰ (“the 1998 Legal Commentary”).

The 1998 Legal Commentary is a useful document against which to assess the utility and the consequences of the construction trust.

Perhaps the most important of the criticisms is that set out in paragraph five of the 1998 Legal Commentary where it stated:

*“The proposed amendment will have significant consequences in the event of insolvencies, in that they will remove what would otherwise be a substantial portion of an insolvent entity’s asset from those assets distributable to creditors. Statutory priorities, established for cogent policy reasons, will be reduced in significance, for example, statutory priority given to employees.”*⁴⁸¹

⁴⁷⁸ Coopers and Lybrand Report p. 34.

⁴⁷⁹ The Inquiry notes that the ACA has itself made a submission to this present Inquiry.

⁴⁸⁰ Joint Standing Committee upon Small Business, Report entitled “Security of Payment: The Full Debate”, August 1998, Parliament of New South Wales, Sydney – Appendix - Document 3, p. (i), para 1.

⁴⁸¹ 1998 Legal Commentary, p. (ii), para 5.

The Inquiry's response

This is the intent and purpose of the construction trust provision. What is to be “removed” from an insolvent entity’s assets are not really assets belonging to the head contractor at all – rather, they are moneys which have only been paid to the head contractor as a consequence of work carried out and materials supplied by the subcontractors.

The contention made amounts to this: that in the event of a head contractor’s insolvency, general creditors should reap the fruits of someone else’s – or more precisely, the subcontractors’ labour. In that model, the rights of general creditors who had nothing to do with generating the payment made by the owner to the head contractor should take priority over the rights of all those whose work and materials have resulted in that payment being made.

Depending upon which side of the policy line one stands, so much else then neatly falls into place. If that advice is contending that a progress payment made by an owner to a head contractor which includes at least 80% of work carried out by subcontractors should be simply gobbled up by other creditors, and if that view carries the day, the whole of the work of this Inquiry in relation to attempts to protect subcontractors is to no avail. If however one takes the view that those circumstances present a quite unjust state of affairs then all else follows.

In dealing with the trust proposal, the 1998 Legal Commentary also provides a brief outline of the Canadian provinces approach to the construction trust including the enactment of trust legislation in various Canadian provinces.⁴⁸² In paragraph 67, the commentary seeks to curb the enthusiasm for the establishment of a statutory trust regime in Australia by drawing support from an extracted passage in the Canadian loose leaf publication *Construction Builders’ and Mechanics Liens* (6th Edition, Macklem and Bristow). After citing this extract, the following evaluation is then made:

- “67. *The comments made [in the Canadian loose leaf publication] concerning the need for any legislative provision to take proper account of business efficacy are particularly pertinent here. What, if any, analysis has been made of the practical consequences of the Amendments? We note the comments in the Green Paper quoted about that “the scheme has potential hidden costs”. Again, we note the many and detailed provisions enacted in some of the Canadian legislation.*
68. *The various Canadian Acts have been in use cumulatively for a period of many years. However, we have not sought or reviewed comments from*

⁴⁸² See the 1998 Legal Commentary, paras 64 to 69.

the Canadian construction industry. No doubt feedback from interested participants in jurisdictions where the same, or substantially similar legislative provision has been made would be extremely useful, particularly in assessing how the Amendments might work in practice (for example, cash flow and accounting implications).’’⁴⁸³

The Inquiry has reached its conclusions after numerous discussions with and written submissions from leading Canadian and American practitioners.⁴⁸⁴

The 1998 Legal Commentary also states that in relation to the proposed statutory trust provisions, it had been:

“advised by the PCA and ACA of the following 4 assertions which have been made by the authors of the Amendments:

- a) no separate trust funds will need to be established (“Assertion 1”);*
- b) contractors would not know the trust exists except in the event of the insolvency of the contractor (“Assertion 2”);*
- c) the practice of major contractors passing money between projects would continue on unimpeded and be unaffected by the proposal provided that their bills are paid, ie for contractors who pay their bills the legislation would be invisible (“Assertion 3”); and*
- d) the proposal would not interfere with normal commercial transactions (“Assertion 4”).’’⁴⁸⁵*

It is said in the 1998 Legal Commentary that each of those assertions “is not correct”⁴⁸⁶.

⁴⁸³1998 Legal Commentary, p.24, paras 67 and 68.

⁴⁸⁴ The Inquiry is indebted to the valuable assistance, information and materials provided by the following American and Canadian practitioners. In Canada: David I Bristow QC, LSM, C.Arb, Arthur L. Close, Q.C., Duncan W. Glaholt (Partner GLAHOLT LLP Barristers and Solicitors), R. Bruce Reynolds, FCARB. (Partner, Borden Ladner Gervais LLP), Master Donald Short (Superior Court of Justice, Masters Chambers Toronto, Ontario); In America: Lawrence C. Melton (NEXSEN PRUET, LLC), Craig E Power (Principal, Cokinis Bosien & Young Attorneys at Law), Kent Collier (Associate, Sutherland Asbill & Brennan LLP), Deborah S. Griffin (Senior Counsel, Holland & Knight), Philip L Bruner ESQ, Jonathan A. Richards (Sr. VP & Regional Counsel Fidelity National Title Group), Bruce Schoumacher.

⁴⁸⁵1998 Legal Commentary, pp.29-30, para 83.

⁴⁸⁶1998 Legal Commentary, p.30, para 84 to 87.

The Inquiry's response

The Inquiry agrees that each assertion is incorrect. The Inquiry does not make or rely upon any of those assertions.

The 1998 Discussion Model - Designated Trust Account

In the Discussion Paper put forward by the Joint Standing Committee upon Small Business in August 1988, it outlined the key features of a "Discussion Model" it had constructed which aimed to "...improve payment performance and security of payments in the building and construction industry".⁴⁸⁷

One of the envisaged initiatives and changes proposed as part of the Discussion Model was that:

*"All registered building contractors who subcontract or purchase building supplies will need to establish a Designated Trust Account....."*⁴⁸⁸

The Designated Trust Account proposed in the Discussion Model is not the statutory construction trust proposal which this Inquiry is recommending. The Discussion Model proposal is too limited and relates more to SOPA by in effect, freezing moneys the subject of dispute until final determination. This Inquiry's proposed statutory construction trust model is not so restrictive as to the scope of moneys to be held in trust or the fluidity by which those moneys would pass through the trust account in the event of a SOPA dispute. The Inquiry's proposal will interweave and enhance the provisions of SOPA which promote a "pay now, argue later" approach.

Advice from the NSW Crown Solicitor's Office

As part of the inquiries made by the Joint Committee upon Small Business into assessing the workability of the deemed trust proposal, the Committee sought:

*".....independent advice from the Crown Solicitor's Office and the Institute of Chartered Accountants as to the likelihood of the deemed trust legislative amendments achieving security of payment in the building industry."*⁴⁸⁹

⁴⁸⁷ Joint Standing Committee on Small Business, Discussion Paper entitled "Security of Payment in the Building and Construction Industry", August 1998, Parliament of New South Wales, Sydney ("the Discussion Model"), p. 8, section 4.

⁴⁸⁸ The Discussion Model, p.19 para 5.6. Further detail on the Designated Trust Account also found at p.26, para 6.6.

⁴⁸⁹ JSC Report, Security of Payment Deemed Trusts: The Full Debate, August 1998, Parliament of NSW, Sydney, p. 6.

Advice dated 1 April 1998 was provided by the Crown Solicitor's Office (CSO) and is included as Document 11 in the appendices to the JSC Report "Deemed Trusts: The Full Debate" ("the Crown Solicitor's Advice"). The NSW Crown Solicitor's Office did not have the benefit of all of the banking, accounting, insolvency, trust account expertise and all of the other written and oral evidence that was before the Inquiry.

The important conclusions in the Crown Solicitor's Advice, which bear upon this Inquiry's recommendation to introduce the statutory construction trust follows.

As part of the response to the question of whether there were "*any matters which would make the operation of the proposed amendment inadvisable or unviable in NSW*" the Crown Solicitor's Advice stated:

*"...I am of the view that the proposed scheme presents very real difficulties in relation to the general law of trusts. It would be different if the legislation was intended as a code, which would operate independently of the law of trusts, but this is not a possibility while there are such major policy issues inherent in the proposal. The most significant of these being (i) the potential to disturb the order of priority of employees and secured creditors and (ii) the potential effect on the conduct of commerce, banking and contractual relationships. Resolution of these policy issues is, of course, beyond the scope of this Office's brief."*⁴⁹⁰

Next in answer to the question:

*"In particular, could the proposed amendment operate in NSW with "deemed trust monies" intermingled with other business cash flows of a contractor without the use of a separate "Trust Account"?"*⁴⁹¹

it was advised that:

"The use of a separate "Trust Account" may overcome some of the legal problems in terms of established trust principles. The operation and administration of a "deemed trust" cuts across two important trust principals (sic), the first of which is the principle that trust moneys may not be mixed with non-trust moneys and the second of which is the principle that beneficiaries of the trust must be identifiable. In the construction chain, particularly on a large project, there could be a large number of 'trustees', and beneficiaries. Each entity in the chain would be a trustee for the entity below it in the chain and the further down the chain one goes, and as the amounts of 'trust money' become smaller, it becomes less likely that these basic trust principles will be, or could

⁴⁹⁰ Crown Solicitor's Advice 1/4/98, pp. 3-4 at 2.1.

⁴⁹¹ Crown Solicitor's Advice 1/4/98, p. 4 at 2.3.

be, adhered to. There is no contractual relationship between an entity down the chain and the entity two or more places higher up the chain, therefore the entity down the chain does not have any contractual remedy against the entity higher up the chain. In addition, an entity down the chain, particularly towards the bottom of the chain, would probably not be inclined to resort to equitable remedy of tracing trust funds to which it is entitled up through the chain. These considerations lead me to the view that while the principle underlying the proposed scheme is one of fairness, the implementation of the scheme by the legislation proposed is not free of difficulty.

While the ‘deemed trust’ could work, it would be very complex and may require amendment to Commonwealth legislation, which may not be politically acceptable.”⁴⁹²

Then it was also said in the Crown Solicitor’s Advice that:

“If the “trustee” is required only to keep separate records of each contract rather than a separate trust account, the potential for exposure by banks to constructive trusteeships is very real. If a ‘trustee’ does not keep a separate trust account in respect of each contract it is difficult to see how the beneficiaries of that trust could be identified. In the opinion of Mr Roger Gyles QC under the proposed legislation contractors could be required to keep separate trust accounts in the same way as Solicitors and Real Estate Agents are required to. Even these in practice cause difficulties.”⁴⁹³

The Inquiry’s response

A separate trust account was what was recommended by the 1998 WALRC Report.⁴⁹⁴ Why? Because it ensures the prominence and continuity of the trust, assists the subcontractors by conferring an additional remedy upon them, an action against any bank found to have assisted with knowledge in a breach of trust. *Barnes v Addy*⁴⁹⁵ is old law and good law. Trust accounts are old hat and familiar to many in the community. Those to whom trust accounts are unknown will be given the opportunity to learn more of their importance.

“Inherent legal and policy difficulties”

In conclusion, the Crown Solicitor’s Advice stated:

⁴⁹² CSO Advice 1/4/98, p. 4 at 2.3

⁴⁹³ CSO Advice 1/4/98, p. 5 at 2.4

⁴⁹⁴ 1998 WALRC Report p. 63 at para 3.32

⁴⁹⁵ (1873-74) LR 9 Ch App 244

“In my opinion there are inherent legal and policy difficulties with the proposed scheme, the most significant of which is the issue of priority as between sub-contractor beneficiaries on the one hand and employees and creditors of the contractor on the other. This difficulty could be overcome by the enactment of parallel Commonwealth legislation. The effect which the proposed legislation will have on the law of contract and the exposure of banks to liability arising from constructive trusteeships are also issues of policy which need to be resolved before the proposed scheme can be brought to fruition.”⁴⁹⁶

The Inquiry’s response

This was not a detailed legal analysis and the Crown Solicitor does not appear to have been briefed in detail or requested to provide detailed advice. There is no attempt made to analyse the contextual proposal that was put up by SOPC and there is no reference to any statutory provision or case law. In the Inquiry’s respectful view, the conclusions in the Crown Solicitor’s advice are not legally correct and present no impediment to the statutory construction trust model proposed by the Inquiry.

If it was that opinion that stood between the proposal and its adoption by the NSW Government in 1991 then the conclusion not to adopt the SOPC proposal was seriously flawed.

It is now appropriate to examine each element in turn.

“.....the proposed scheme presents very real difficulties in relation to the general law of trusts”

The advice does not indicate how or in what respect there is said to be a clash. The legislation sets up a trust to which the general law of trusts applied unless those rules have been expressly varied by the legislation itself, a matter to which the Inquiry will come to in a moment. As Ettinger points out:

“A statutory trust is still basically a trust and as pointed out by Mr. Justice Martland in John M.M. Troup Ltd. v. Royal Bank of Canada, “(a)lthough the trust is created by statute, it thereupon becomes subject to the application of the rules of equity”. We will see that this means that the rules of equity apply unless

⁴⁹⁶ CSO Advice 1/4/98, p. 5 at para3.

they have been specifically displaced by the very terms of the statute or, in the opinion of the court, by necessary implication.”⁴⁹⁷

The established rules of trusts have been varied and varied with clarity in the following senses:

- There has been a statutory obligation to pay the beneficiaries within 28 days established by the statute;
- It has been made clear that the same investment regime under the Trustee Act applies to the statutory construction trust;
- It has been made clear that as was probably the case anyway, the trustees are entitled to retain interest on the fund for the period between the date of payment by the owner/principal and the date of payment out to the subcontractor.

“...the potential to disturb the order of priority of employees and secured creditors”

The statement made in the advice that there will be a disturbance in priorities is not accurate. No question of priorities between employees and secured creditors will be disturbed for the simple yet compelling reason that the funds in the statutory trust fund which are due to be paid to subcontractors do not fall within the pool available to employees and secured creditors.

“...the potential effect on the conduct of commerce, banking and contractual relationships”

The advice does not detail what is meant by the “effect on the conduct of commerce, banking and contractual relationships”. There is no evidence in the period since 1932 when such trusts had been first employed in Manitoba, Canada of any breakdown of commercial banking contractual relationships nor is there any reason to entertain the speculative conclusion that there would be such a breakdown here in NSW. There was no specific evidence to that effect given before the Inquiry.

In Ettinger’s article on “Trusts in the Construction Industry”, the learned author makes the following comments on Manitoba’s legislative history and proposals for reform of trusts in the Canadian construction industry:

“Manitoba was the first province to adopt a statutory trust scheme in its builders’ lien legislation in 1932. Ontario introduced similar legislation in

⁴⁹⁷ Ettinger, L. P., “Trusts in the Construction Industry” (1988-1989) 27(3) *Alberta Law Review* 390 at 402.

1942. British Columbia followed suit in 1948 and New Brunswick in 1959....”⁴⁹⁸

“...Manitoba also flirted with the idea of removing the trust provisions from its builders’ lien legislation. The Manitoba Law Reform Commission in its 1979 Report pointed out that the then current fines and penalties for breach of trust were ridiculously low and prosecutions were rarely undertaken either pursuant to provincial legislation or the Criminal Code. In addition, it was suspected that the provisions made banks and other lending institutions reluctant to provide normal financing arrangements within the construction industry. The Commission acknowledged that it had found, however, no evidence of any impediment to financing and indeed found general favour for the trust scheme within the construction industry. As a result, its recommendations included retention of trust provisions...”⁴⁹⁹

“...The recommendations of the [Alberta] Task Force with respect to the adoption of trust provisions may be summarized as follows:

1. There should be a comprehensive trust scheme similar to that in Saskatchewan and Ontario, i.e. all moneys received on account of the contract price for the improvement are held in trust for the benefit of those with whom the trustee has contractual privity. The trustee’s obligations should be discharged only when he has satisfied all his outstanding accounts, or when there is no more trust money.”⁵⁰⁰

Summary

In the firm view of the Inquiry, the content of the Crown Solicitors advice dated 1 April 1998 does not present any sound reason for not implementing statutory construction trusts in NSW.

2001 Western Australian Taskforce Report

It will be remembered that in a detailed and closely reasoned report, the Western Australian Law Reform Commission headed up by Mr Wayne Martin QC as he then was, made a series of recommendations to the Western Australian Government. Those

⁴⁹⁸ Ettinger, L. P., “Trusts in the Construction Industry” (1988-1989) 27(3) *Alberta Law Review* 390 at 393.

⁴⁹⁹ *Ibid.* 395.

⁵⁰⁰ *Ibid.* 397.

recommendations were not implemented. In order to understand something of the reasoning lying behind that decision it is necessary to examine the report prepared by The Security of Payment Task Force for the Western Australian Building Industry in November 2001 entitled “Report to the Minister for Housing and Works” (“2001 WA Taskforce Report”).

Some important findings were made by the Taskforce which are apposite to the work of the present inquiry. On the effects of security of payments issues, the 2001 WA Taskforce Report stated that:

“Security of payment issues can have a damaging effect on both individuals and their families and on the health and efficiency of the industry as a whole. The pyramidal structure of the construction industry can rapidly multiply the negative effects of partial, non and slow payment down and through the industry. A payment problem at any point in the contractual chain may choke cashflow further down the chain and result in further slow or non payments, hence exacerbating the problem. Because of the very tight margins in the industry, restricted cashflow and payment default can force good operators into bankruptcy which can reduce the number of skilled operators in the industry and could result in skill shortages and subsequent delays and price rises. Resolving payment disputes under the current court system can be costly for individuals and the industry as a whole, where legal expenses, time delays and damage to good working relationships may result. Disproportionate contractual relationships can result in an “us and them” mentality and inhibit more productive, co-operative partnerships evolving.”⁵⁰¹

On the participants of the industry the 2001 WA Taskforce Report stated:

“The commercial construction industry is a wide and diverse area where contracts and subcontracts can be for many millions of dollars and where participants can range from small local businesses to wealthy multi-national corporations. Participants in the commercial construction industry must have business and commercial capability commensurate with their contracting partners and relationships are usually regulated by written contracts.

Because of the greater technical sophistication in commercial construction, subcontractors are usually substantial businesses in their own right, and subcontracts include supply of materials and labour. As a result, an insolvent or slow paying subcontractor may have significant impact on the industry by starving smaller subcontractors and suppliers of cash flow down the contracting chain.

⁵⁰¹ 2001 WA Taskforce Report, p 9.

Expect in specialised circumstances, prices in the commercial sector are usually determined by collecting subcontract prices and amalgamating these to give an overall tender price. In theory this allows the person bidding for the work to set the price and avoid taking on projects at a loss. However it also relies on contractors having sufficient knowledge of their cost structures to set commercially realistic tender prices. There is anecdotal evidence to suggest that one of the main payment issues in the commercial construction industry is insolvency as a result of naive business practice and persistent under-quoting on jobs.

Participants in the commercial construction industry are more likely to limit liability through the use of “two-dollar” companies and trust structures so that personal assets are not put so much at risk in the event of insolvency. Because the consequences to the business owner are not so severe with these types of structures it seems plausible that owners may allow a company to fail through insolvency rather than commit external funds to discharge debts further down the chain. The industry has reacted to this issue of undercapitalised corporate structures by requiring personal or parent company guarantees, but in a competitive market those more desperate to win work will take greater risks. The result of this is that the core of the industry, made up of well run, properly capitalised businesses with good track records and sound ethics has constantly to compete for work against less reliable, higher risk businesses.”⁵⁰²

On payment issues:

“The two main security of payment issues are slow or disputed payment and insolvency of someone in the contracting chain. While there are limited statistics available dealing with insolvency and bankruptcy in the construction industry, there is no real evidence to demonstrate the extent of slow payment problems and their effect. Despite this there is strong anecdotal evidence of the types of problem and the reasons for them.”⁵⁰³

On business and financial practices:

“As in any industry, poor business practices will lead to disaster. The construction industry is perhaps more prone to this because it is usually technical skill rather than business acumen that induces people to become contractors or subcontractors. Particularly amongst smaller contractors, the key personnel are usually engaged on site during the day, and attempt to

⁵⁰² Ibid, p. 7.

⁵⁰³ Ibid, p. 7-8.

manage the business at night or with the assistance of a spouse or other family members. As a result, it is likely that many contractors do not have good day by day understanding of the financial health of the business. An unexpected financial crisis is more likely to end in insolvency than one which has been foreseen and managed before it became critical.

Because the mainstream construction industry is heavily fragmented and specialised with capital equipment usually available for short-term hire it is possible to commence contracting in the industry with very little working capital. So long as there is timely payment for work done, and suitably generous terms of trade and credit available from suppliers the business can survive on very high gearing or even cash flow alone. Although suppliers are often aware of the risks they run in dealing with undercapitalised contractors, anecdotal comments made to the Taskforce suggest that refusing credit is not a viable option to most suppliers.”⁵⁰⁴

On contract and risk management:

“The building and construction industry is heavily based on the use of specialist subcontractors actually doing the work. Head contractors are essentially responsible for arranging and coordinating the work. In structuring this way the industry has effectively made the subcontractors and suppliers finance construction by the use of techniques such as:

- *Extended credit and payment terms for subcontractors and suppliers, so that (for example) if the head contract provides for payment in 28 days the subcontract may provide for 60 or 90 days. This allows sufficient time for the subcontractor to do the work, the head contractor to claim and get payment from the owner, and for the head contractor to pay the subcontractor within the term allowed by the subcontract. In more extreme cases the subcontract only requires the head contractor to ‘pay when paid’ or ‘pay if paid’ so that there is no risk or financial draw on the head contractor at all. “Pay when paid” and “pay if paid” provisions in contracts are particularly objectionable to subcontractors because the head contractor is under no commercial pressure to seek payment from the owner, and privity of contract prevents the subcontractor from taking action against the owner directly.*
- *Transfer of risk to the contractor or subcontractor by the use of “guaranteed maximum price” contracts or removing grounds for claim for matters such as inclement weather, industrial disputes, and the like. Subcontractors are particularly vulnerable to these types of contractual provisions because they*

⁵⁰⁴ Ibid, p. 8.

*may not receive all the contract or tender documents when pricing the work and may not be aware of risks that should be priced, managed, or transferred.*⁵⁰⁵

On unethical conduct:

“Even when contractors or subcontractors have been able to make a fully informed assessment of the work and tender accordingly, some forms of unethical conduct in the industry can be used to reduce margins or impose further risks. These include:

- *Bid shopping, where the lowest tender price is used as the basis for seeking even lower prices from other tenderers.*
- *Transfer of costs from contractor to subcontractor, such as site allowances negotiated by the head contractor but paid by the subcontractors.*
- *Underpayment of claims, where less than the full amount is paid in the knowledge that the cost of recovering the debt through the courts is too long and expensive to be worthwhile.*⁵⁰⁶

The Inquiry respectfully agrees with all of those findings.

That part of the 2001 WA Taskforce Report which concerned itself with insolvency hardly, with respect, does justice to the 1998 WALRC Report. It stated:

“The next most significant problem in security of payment is insolvency in one part of the contracting chain, thus preventing contract payments from proceeding to subcontractors and suppliers. An insolvent party is likely to have diverted contract payments for current work to shore up long-standing and now pressing debts rather than pay subcontractors and suppliers for the work on the current project. When insolvency finally occurs the assets that are left must be distributed in accordance with the Bankruptcy Act of the Commonwealth and to secured creditors before unsecured creditors. The terms of trade of most building contracts make the contractor an unsecured creditor of the principal and thus rank last in the distribution of available funds.

Legislation could be used to improve the status of contractors, subcontractors and suppliers in the event of insolvency. The Law Reform Commission and others have recommended legislation to establish

⁵⁰⁵ Ibid, p 8

⁵⁰⁶ Ibid, p 8-9

statutory trusts covering contract payments, and thus keep such funds outside the operation of the Bankruptcy Act. This recommendation is based on a constitutional position that the States cannot act unilaterally to change an Act of the Commonwealth and the imposition of trust status on funds to be administered in insolvency is a “back door” way of changing the order of distribution of funds prescribed in the Bankruptcy Act.

The Taskforce examined a range of statutory trust models to provide for the protection of outstanding monies in cases of insolvency.

However, after carefully considering advice from the WA Crown Solicitor’s Office and the research and conclusions of other jurisdictions, the Taskforce does not recommend State legislation to establish a statutory trust regime as it believes the need to administer contract payments in a trust framework will impose a disproportionate and unfair burden on contractors. The Taskforce believes that the protection of outstanding monies in circumstances of insolvency cannot be cost effectively achieved via State legislation and would [be] better addressed via amendment of the Commonwealth Bankruptcy Act.

The Commonwealth Government has recently indicated a willingness to amend its Bankruptcy Act to increase protection to funds owed to workers when an employer becomes insolvent. The situation for small contractors is similar to that of workers and the particular circumstances in construction where title passes to the landholder deserve special consideration. The Taskforce recommends that the State approach the Commonwealth to amend the Bankruptcy Act to provide protection for unpaid contractors similar to that proposed for employees of insolvent companies.”⁵⁰⁷

In the Inquiry’s view with respect, the decision not to implement the recommendation of the 1998 WALRC Report is mystifying at best but for present purposes what is important is that no reasons were put forward for that decision except that it would “impose a disproportionate and unfair burden on contractors.”⁵⁰⁸

In view of the depth and quality of the 1998 WALRC Report on this issue the Committee’s response to it, inadequate though it may be, requires some comment.

⁵⁰⁷ Ibid, p. 17.

⁵⁰⁸ Ibid.

The Inquiry's response

At the heart of the 2001 WA Taskforce Report recommendation is the unsupported statement that:

“...the need to administer contract payments in a trust framework will impose a disproportionate and unfair burden on contractors.”⁵⁰⁹

This conclusion is rejected by the Inquiry. The Taskforce went onto say that it also believed:

“[T]hat the protection of outstanding monies in circumstances of insolvency cannot be cost effectively achieved via State legislation and would be better addressed via amendment by a Commonwealth Bankruptcy Act. The Commonwealth Government has recently indicated a willingness to amend its Bankruptcy Act to increase protection to funds owed to workers when an employment becomes insolvent. The situation for small contractors is similar to that of workers and the particular circumstances in construction where title passes to the land holder deserve special consideration. The taskforce recommends that the State approach the Commonwealth to amend the Bankruptcy Act to provide protection for unpaid contractors similar to that proposed for employees of insolvent companies.”⁵¹⁰

The Inquiry's response

The Bankruptcy Act is irrelevant to the problem under examination. The trust protects the principal's payment and adds to the likelihood that subcontractors will be paid 100 cents in the dollar for the progress claims in the trust account. The Inquiry does not hold the view that s. 556 of the Corporations Act should be amended so as to give some greater protection to subcontractors.

Queensland Building Services Authority Discussion Paper, December 2001

A security of payment discussion paper issued by the Queensland Building Services Authority in December 2001 made reference to the statutory construction trust and commented that:

Under the heading “Deemed Trust the following appears:

⁵⁰⁹ Ibid

⁵¹⁰ Ibid.

“The Authority’s research has found that during the last five years, the Governments of Queensland, New South Wales and Western Australia have all considered Deemed Trusts as a possible solution to security of payment for subcontractors. Under such a scheme a contractor receives progress payments upon trust to pay workers, subcontractors and suppliers. Only the balance (after workers, sub-contractors and suppliers have been paid) becomes the property of the contractor.

With regard to Queensland and NSW, the Governments concerned rejected the implementation of such a scheme for a number of reasons, the primary ones being:

- *Serious legal shortcomings – need to resolve involvement of third parties, effect on funds in case of dispute, requirement for complex drafting making legislation unworkable in practice;*
- *A likely increase in the cost of building projects because of shortened payment cycles, thereby making finance more expensive;*
- *The failure to guarantee that sub-contractors would get paid;*
- *The lack of support across the industry eg. property council, financial sector and builders strongly opposed to the introduction of such schemes;*
- *The administrative cost burden – greater monitoring of bank accounts, additional administrative procedures in agencies and contractors for identification of funds, increased training for builders and subcontractors.*

In respect of Western Australia, a taskforce, established in October 2000 to advise the Government on security of payment options, has recently submitted a report to the Government in which it recommends against the establishment of a trust scheme. The taskforce, in making such a recommendation, was significantly influenced by advice from the Western Australian Crown Solicitor’s Office, as well as research and conclusions from other jurisdictions, which all pointed to the administration of contract payments in a trust framework as imposing a disproportionate and unfair burden on contractors.”⁵¹¹

The Inquiry firmly rejects each of these criticisms.

The fact the criticisms have been made is of course an extremely useful part of the process of law reform and the Inquiry welcomes the opportunity to deal with each of those submissions so that Government and its policy advisors may approach the

⁵¹¹ 2001 QBSA Discussion Paper, p.6.

criticisms and measure them alongside the Inquiry's responses. Those responses will be considered under the headings of some general considerations and then each of the particular criticisms will be dealt with in turn.

General Considerations

Commentary and analysis of the trust have been bedevilled by the repeated, unsupported assertions, without reference to any evidence. These criticisms have endeavoured to dismiss the idea without either looking in depth at what is proposed and apparently without speaking to practitioners from those jurisdictions in Canada and the United States where the trust does operate. It seems to the Inquiry that incantations, for example of "complex drafting making legislation unworkable in practice", "finance more expensive", "the administrative cost burden" do not really help in resolving what is after all an important debate.

If such vague generalisations enjoyed support one would expect it to be catalogued.

Serious legal shortcomings

*"Need to resolve involvement of third parties, effect on funds in case of disputes, requirement for complex drafting making legislation unworkable in practice."*⁵¹²

No serious legal shortcomings have been pointed out to the Inquiry from the numerous people to whom the Inquiry spoke in detail in the United States and Canada. The Cole Royal Commission accepted that the trust would work. The Inquiry's legal analysis of the particular model recommended against the background of decades of operation in Canada does not suggest any serious legal shortcomings. Mr Gyles QC has also expressed the opinion that "such a trust would be legally effective."

As to the effect on funds in the case of dispute, nothing that anybody has written suggests to the Inquiry that the legislation "is unworkable in practice". All of the Canadian experience referred to in the textbooks, in the decided cases and in the detailed conversations this Inquiry had with practitioners in Canada and in the United States suggest otherwise.

As to the effect on funds in the case of dispute, there is nothing that can resolve the impossibility of achieving an instant resolution of a complex construction dispute.

The way in which the proposal dovetails with existing Government policy as expressed in SOPA suggests that this criticism may also be overstated. The fact that there might be a dispute about some of the moneys in question does not in any way diminish the

⁵¹² 2001 QBSA Discussion Paper, p.6.

utility of a mechanism which delivers those funds not in dispute to those claimants in the chain who can demonstrate that the claimed moneys are due and payable. As to the requirement that the drafting can be complex, that particular complaint may be resolved almost instantly by examining the proposal in the recommended legislation which it is respectfully suggested does not meet the description of “complex drafting”.

In the 28th edition of Australian Construction Law Newsletter (ACLN) the Electrical Contractors Associations of Australia Limited analysed the AFCC Discussion Paper on insolvency in the Building and Construction Industry which had been published in an earlier ACLN issue No 25 page 56 (1992). In its submission Electrical Contractors Associations of Australia Limited said:

“Trust is a practical, simple and cost effective way to ensure payment, by creating an obligation on the contractor to hold progress payments in trust for the benefit of workers, subcontractors, professional parties and suppliers.

A submission on these lines, prepared for the NSW Government, makes the case for trusts on the basis that they are just, equitable and practical. There can be no valid objective to suggest otherwise unless the motive is to retain the status quo and go on allowing head contractors to finance their businesses – and sometimes other risky business! – using money which rightly belongs to subcontractors.”

In an article entitled “Common Law and Statutory Trusts: In Search of Missing Links”, Grenon also makes the point:

In conclusion, simple statutory trusts – that is, trust created by statute in cases in which there exists identifiable or traceable property impressed with the trust – are valid trusts and, as such, are subject to general rules of trust law. Trusts created pursuant to construction lien legislation fall within this category.⁵¹³

The legal and moral validity of that proposition remains unassailed.

Summary of the position in Australia

That is an outline of the position in Australia.

⁵¹³ Grenon, A., “Common Law and Statutory Trusts: In Search of Missing Links” (1995-1996) 15(2) *Estates and Trusts Journal* 109 at 134

One can conclude with confidence that the legal structure and efficacy of the construction trust have been the subject of numerous inquiries conducted in several different parts of Australia in considerable depth and detail by a number of highly qualified lawyers. In no case has it been found wanting.

The construction trust has been criticised by the Andersen Report and the Coopers Lybrand Report for essentially the same speculative and non-specific reasons. These criticisms have been picked up and repeated without further analysis in other reports. They are unsound and ought to be placed to one side.

Banking practices

One of the key considerations to be kept at the forefront of the mind of any law reformer is the question of unintended consequences. There are times when what appears on its face to be a rosy solution to a knotty law reform question, throws up unintended consequences of such magnitude that the reform itself is soon shown to be inappropriate. In the present case it is necessary to examine the way in which construction companies do business with their banks in order to explore the possible effect of some of the recommendations which have been made in this Report.

One neat way of introducing considerations of that nature is to refer back to the earlier quote from Brian Silvia who said that:

“The introduction of a trust concept will..... represent a major impact on banking facilities currently enjoyed by builders. The work in progress element of a builder’s balance sheet more often than not is pledged in favour of a bank supporting an overdraft facility under a debenture charge.”⁵¹⁴

It will serve to assist the analysis if something more is said about Mr Silvia’s reference to “*the work in progress element of a builder’s balance sheet*” By that Mr Silvia was referring to the position prior to the forwarding of a progress payment claim by the building contractor to the principal. In discussions with Mr Silvia it was made clear that his reference to work in progress was, as the Inquiry originally suspected, a reference to all of the work carried out in the particular building project which as the Inquiry has found is genuinely completed as to 80% by subcontractors.

Plainly then, if a bank is taking into account that money it must also take into account the fact that within a relatively short period the head contractor will be required to pay out about 80% of the progress payment to the subcontractors who have carried out that amount of work.

⁵¹⁴ Brian Silvia, BRI Ferrier, Letter dated 16 October 2012.

For that reason it would not be appropriate for any bank to regard what has been said to be “work in progress” as a genuine security component in any borrowing or lending transaction in which the bank and the building contractor were involved. When answering the question “whose work in progress” the answer will be in accordance with building practices which are now not in dispute, subcontractors who carry out the lion’s share of the work.

For those reasons it can be seen that a bank would not be entitled to regard itself as entitled to that money without also taking account of the fact that its client will be required to pay at least 80% of it out to subcontractors who are legitimately owed that amount.

In the view of the Inquiry that is not what banks do anyway. Accountants from the larger practices in Sydney told the Inquiry that banks do not falsely inflate their clients financial position by including within the customer’s net worth, money destined for subcontractors.

Upon the introduction of the construction trust by statute it will not be possible for a bank to regard that amount of money as an appropriate backing for any financial facility afforded to its client building contractor. The statutory construction trust recommended by the Inquiry will resolve clearly the question whether or not a bank should ever regard itself as being “entitled” to that money in any circumstances.

The proposition advanced by Mr Silvia underlines the importance of there being no moment, no period of time in which the payment of a progress claim to a head contractor remains in a bank account owned and maintained by the building contractor.

For those reasons together with the avoidance of any possible preference argument, the Inquiry sees the introduction of a statutory construction trust as a welcome step forward and one, which seen in that light, is an improvement upon the rather hand to mouth world in which a bank could step in at any moment and assert its claim to moneys which have only gotten their way into the bank’s client account by reason of work having been carried out by subcontractors.

That view of the approach presently taken by banks was confirmed by the financial services firm PPB Advisory, in its submission to the Inquiry dated 2 November 2012 in which it was said:

“In an ideal world, banking facilities to head contractors should be based solely on the gross margin component of the WIP⁵¹⁵ (less operating costs). In essence,

⁵¹⁵Work in Progress.

head contractors should have sufficient cash on hand or collateral security to fund the deferred receipt of their profit until the end of project. Receipt of monies destined for subcontractors should in reality only be on hand for a day or two and hence should have no value to financiers in any event.

However, in reality:

- *It is currently common practice for banks to lend to contractors holding the work in progress element of the contractors balance sheet as security.*
- *As such, any trust arrangement which quarantines work in progress funds will deprive the contractor of security.*

*Whether this lending is right or wrong it occurs. While the business continues to trade, it represents few problems. It is only in the event of a default by the contractor that the bank step[s] in and take[s] priority over funds originally destined for the subcontractors”.*⁵¹⁶

The submission made by PBB Advisory of course puts the problem in a nutshell - *“it is only in the event of a default by the contractor that the bank steps in and takes priority over funds originally destined for the subcontractors.”*

An eminent Canadian practitioner put it this way:

*“From the perspective of the Inquiry, and putting to side the issue of whether the law is observed (a concern that is, in my view, significantly reduced by the use of an actual trust account), I think there is a clear policy decision to be made here, i.e. whether the importance of protecting the solvency of trade subcontractors outweighs the importance of maintaining cash-flow of head contractors. If the former policy objective is favoured then the head contractor will be unable to pay itself any amount from the trust account until everyone else has been paid...”*⁵¹⁷

The material prepared by Mr Silvia and drawn to the attention of the Inquiry was of such a nature as to suggest to the Inquiry that the view of the Australian Bankers Association should be sought and obtained.

In responding to the question, how do banks view the progress payments made to head contractors for work predominately performed by subcontractors, the Australian Bankers Association, while not providing comment on the issue of security, simply said:

⁵¹⁶ PBB Advisory e-mail submission prepared by Mr Ben Webber, Senior Analyst, 2 November 2012.

⁵¹⁷ Bruce Reynolds, Partner Border Ladner Gervais (BLG), Ontario, Canada, letter dated 6 November 2012.

“.....a bank is entitled to rely, without inquiry, on the payment instructions of the account holder. Progress payments will be made at the request of the owner/principle (sic) to the head contractor, with the bank having the option of confirming that the necessary work has been completed. The bank will not have line of sight of arrangements for payment made between the head contractor and any subcontractors.”⁵¹⁸

Again, the comments from John Melliush, Ferrier Hodgson are instructive. In relation to the role of the banks and how they may view or treat the payment of progress moneys by the client to the head contractor, he said:

“The account [trust] should reference the head contractor entity as trustee and note the existence of the fact that this is a trust account, however I would be surprised to see any financial institutions involved in the enforcement of Trust arrangements, other than to be on notice that these are trust finds and not to be taken into account in the assessment of any security position. It may be alleged that this arrangement will negatively impact the financial position of the head contractor. In my view the delay in payments to subcontractors should not be seen as a funding source for head contractors.”⁵¹⁹

Mr Melliush goes further and makes a telling observation about the modification of behaviour that can be brought about through the introduction of the statutory trust:

“In my view the trust account process will allow the earlier identification of losses, and reduce the potential for project losses to snowball, by reducing the availability of unpaid subcontractor monies to cashflow continued operations. In addition this process will require participants to be better capitalised which will benefit the stronger players in the industry.”⁵²⁰

The Inquiry also heard from Mr Bruce Gleeson, Principal of Jones Partners, Insolvency and Business Recovery Chartered Accountants, on the issue of the proper consideration of progress payments made to the head contractor who stated that the trust mechanism:

“.....does not change the liability of the contractor. There is no change to the financial position.”⁵²¹

The Inquiry’s suite of recommendations are aimed at addressing the causes of insolvency while noting that there is no wholesale antidote that can be applied to the

⁵¹⁸ Australian Bankers Association, Submission dated 13 November 2012.

⁵¹⁹ John Melliush, Partner Ferrier Hodgson, p 2.

⁵²⁰ Ibid p 3.

⁵²¹ Bruce Gleeson, Principal, Jones Partners, teleconference, 8 November 2012.

industry to protect its participants from their own insolvency or the effects of others. Some recommendations such as licensing, coupled to financial and capital requirements aim to better protect industry participants by ensuring they are appropriately equipped to work on projects of an identified scope and range. The education and training recommendations ensure that more eyes are open to the real risks and how best to avoid, manage or price them appropriately. These preventative measures are combined with the trust protection to offer subcontractors effective and ongoing protection when insolvency of the head contractor does occur.

To those who have expressed, although in general and unsupported terms, opposition to the statutory construction trust there are a number of important comments which should be made, each of which significantly ameliorate consequences of the implementation of the trust. In doing so they more than answer the criticisms that have been made, but that is not the point of emphasising these considerations at the moment. What is sought to be done is to demonstrate that there is no rational justification to fear the statutory construction trust which after all, is designed as are each of the interconnected recommendations made by the Inquiry, to ensure that just claims for payments for work done by any participant in the building and construction industry are properly dealt with in a way which affords a balanced and equitable protection to all those involved.

The four considerations to which the Inquiry refers of which it invites analysis in a balanced examination of the statutory construction trust proposal are:

- i) That the proposal be implemented only after a considerable period of notice has expired to enable those affected by its operation to properly prepare for and put their house in order to comply with the new law. If this means that participants in the industry are required to adjust to a period of existence in which they are no longer able to play fast and loose with money which is not in reality their own, then so be it and no apology ought be made for that consequence.
- ii) The statutory construction trust as recommended, is one in which the freedom of scope is expressly preserved for the building contractor to invest moneys during the payment cycle.
- iii) Similarly the Inquiry's recommendations enable the building contractor to retain profits made by reason of such an investment during the period leading up to the time at which the payment out of the account must be made to the subcontractor.
- iv) As the overall intention of this pattern of measures recommended by the Inquiry is to ensure the rapid deployment of moneys justly owing to parties within the relationship under examination, building contractors will be heartened to know that this is not a one way street in the sense that the Inquiry recommendation for prompt payment in 15 days of the receipt of a progress claim applies with equal force to the principal in its dealing with the head contractor and so as the saying goes, what is sauce for the goose is sauce for the gander.

Opposition to the Construction Trust

After many discussions with interested parties upon the subject of the introduction of the construction trust the overwhelming evidence demonstrates that opposition to the introduction of the construction trust is born out of misunderstanding. That is not too difficult to appreciate because the genius of the trust is that it is not an impediment yet at the same time it is the most effective guarantee against the loss of moneys that should have been passed on to the subcontractor. By far the greater part of the opposition to the construction trust may be put down in the view of the Inquiry to the perfectly understandable lack of knowledge in the building and construction industry of the trust device itself.

In the practical sense and in the real world, the construction trust will not place a heavy hand upon the conduct of those in the building and construction industry – its real role will only be demonstrated and become prominent if and when an insolvency occurs. The trust will then ensure that moneys that have been ring fenced are not available in the general insolvency of the company.

It is going too far and it is unnecessary, to say that the construction trust is “invisible” whilst ever the head contractor is busily trading in a state of solvency making profits and paying its creditors. However in one important sense whilst everything is going along as it should, moneys are simply being passed through the trust at greater speed with greater safety to their proper and ultimate destination namely the subcontractors. It is difficult if not impossible to see anything wrong with this regime.

Let the matter be tested in this way. In the absence of any insolvency it is business as usual except for the requirement that one new account be opened up for the total number of contractors projects and that that account be as it were, monitored by the head contractor in much the same way that any prudent business monitors the state of its bank account by looking at the deposits and the withdrawals and keeping a weather eye on all of the types of things that a business should be conscious of, for example upcoming payments to creditors and so on.

Summary

Resolution of the most important issue assigned to the Inquiry by the Terms of Reference, boils down to two overriding questions. With varying degrees of intensity, some but certainly not all of the head contractors who gave evidence to the Inquiry, wish to be left unrestrained in the way that they deal with the cash in their bank account

which is there because the subcontractors have done 80% of the work and it is there because it is intended to be paid to the subcontractors whose work gave rise to payment.

In the Inquiry's view, the answer to this question is as provided by the Canadian provinces and the American states that have decided to implement a construction trust. That decision was no doubt based upon the moral imperatives of the situation. As Reynolds explains:

*“In policy terms, Canadian governments long ago accepted the proposition that both legislative and administrative steps must be taken to manage the heightened risk of insolvency which is inherent in the construction industry, and implemented a safety net of such mechanisms. The major protective mechanisms are liens, hypothecs, statutory trusts, surety bonds, and restructurings. This safety net of protective measures has, in fact, been enhanced over the years, and although it is less than a perfect preventative, has undoubtedly had the effect of minimising insolvency in the industry, particularly during the major Canadian recession of the early 1980s and the early to mid-1990s.”*⁵²²

The second main issue appears to be that for some reason which has not been advanced with any particularity or supported by evidence, that there will be an adverse effect upon financing arrangements in the industry.

The answers to that are as follows:

- i) that has not been the position with Canadian provinces;
- ii) financiers can legitimately take into account that part of the progress payment made by the owner which includes payment to the head contractor;
- iii) banks cannot ignore the reality that the money has been earned by the subcontractor and in so doing has created a liability in the head contractor to pay the subcontractor;
- iv) it is doubtful that subcontractors would willingly carry out the subcontract work if they in truth knew that the money could be taken by a bank at any time.

The third issue is the perennial complaint made concerning the additional administration record keeping and cost. These criticisms have been dealt with earlier.

⁵²² Reynolds, B., “A Canadian Approach to the Minimisation of Construction Insolvencies”, ch. 5 in Davis R. and Odams, M. (eds), *Contemporary Issues in Construction Law*, vol.1, Security for Payment, 1996, Construction Law Press, Centre of Construction Law & Management, King's College, London, pp. 117-162 at 118.

In the Inquiry's view it is legitimate for Government to approach the construction trust as if those criticisms were the only remaining valid criticisms to which serious attention should be given.

An interesting aspect of the Australian Bankers submission to the Joint Standing Committee on Small Business on 6 March 1998 is its unconsciously important contention that:

“If payments received by a head contractor are impressed with the trust, not only will those monies not be available to service the normal working capital requirements of the head contractor, i.e. cash flow requirements, but also the head contractor would be unable to derive any personal benefit from having those funds standing to the credit of the account. For example, an interest off-set arrangement involving the trust account and the personal borrowings of the head contractor could not be entertained by a bank. This is a clear financial implication for the head contractor of the trust arrangements. In other words, the flexibility of a bank in providing financing arrangements for the head contractor will be limited by reason of the existence of the statutory trust.”⁵²³

There are a number of immediate and conclusive answers to the proposition advanced by the bank and quoted in the preceding paragraph. Firstly why should moneys which have only been paid to the head contractor because the subcontractors have done 80% of the work, be treated willy nilly by the head contractor without regard to the rights of the subcontractor. Secondly the oft heard complaint about cash flow ignores the rather fundamental proposition that the principle requirement for cash flow is to pay the subcontractors. Thirdly the proposition that the funds in the trust account will not be available to service the normal working capital requirements of the head contractor is contrary to undisputed fact that the amounts also legitimately owing to the head contractor will be identified in the payment by the owner and will stand to the credit of the head contractor's account. Fourthly as to the notion that the head contractor would be unable to derive any personal benefit from having those funds standing to the credit of the account, those advocating the interest of the subcontractor would say “what's wrong with that?”. However the Inquiry's answer is perhaps a more balanced and nuanced one. One particular recommendation made by the Inquiry will enable the head contractor to contain the benefit of those funds standing to the credit of its account for the period commencing with their deposit into the account and ending with their proper payment out in accordance with the statutory prompt payment provision, to the subcontractor.

⁵²³ See pages 2 and 3 of the Australian Bankers Association submission.

Another insightful example of the unconscious and misplaced reliance upon moneys in fact due to others may be found in the submission to the Inquiry by a national industry body.

In a passage which is reminiscent of the passage quoted immediately above from the Australian Bankers Association submission:

“For subcontractors and builders the maximum payment terms should be 45 days, and preferably 14 or 30 days. Builders often need alternative income to survive, and often become developers (and not just contractors) to try to secure their financial position.”⁵²⁴

This statement stands at the philosophical divide exposed by this and numerous earlier inquiries. Whatever alternative income source builders may require, that income source cannot be secured and availed of by taking moneys owing to the subcontractors. That is the position upon which this Inquiry takes its stand and if legislators have a contrary view then they will read the Inquiry’s report and make recommendations accordingly.

There are other examples where in a frank and disarming manner other witnesses to the Inquiry have made it quite clear that builders expect to have a completely free hand in the manipulation of moneys that have only been paid to them as a consequence of the subcontractors work

The unconsciously erroneous assumption

The Inquiry has made mention of the philosophical divide in which different organisations take different views about the so called “entitlement” to utilise funds “sitting in bank accounts”. Another example of that may be found in the submission referred to above from a leading national body. In citing this example, the Inquiry does not intend to be critical of the position taken by those who have made submissions to it. It welcomes such submissions and the opportunity to invite consideration of that party’s perception and to participate in a process in which an understanding might be developed within the industry that the opportunistic resort to “any funds sitting in bank accounts” is not an acceptable practice when it is at the expense of the subcontractors.

That submission said:

⁵²⁴ Witness to the Inquiry.

“Currently the construction industry is about cash and cash flow not investments.⁵²⁵ Any funds sitting in bank accounts need to be “at call.” There is a lack of money in the construction industry, and builders often put their family home at risk for financing building projects.”⁵²⁶

The submission also stated that *“any funds have to be at call to assist with cash flow.”*

The answer of course to those contentions is that “Peter can’t be robbed to pay Paul”. Funds that are sitting in bank accounts only because the builder is being paid for work which has been 80% carried out by subcontractors are not entitled and should not be entitled to place those funds in jeopardy by putting them to use outside the payment cycle in any of the ways referred to previously in this Report.

The same submission also set out concerns relating to the construction trust account and it is important because it indicates that there is a significant level of misunderstanding in the construction industry concerning these trusts. The submission said:

“A system where a New South Wales Government agency would hold the sum or all (sic) the funds and take the interest would not help with cash-flow on construction. Investments may or may not turn profit or even survive as an investment, and the money does not belong to the Government to invest in the first place. Thus, the (organisations) is opposed to this type of scheme.”

Upon reading this submission it was immediately apparent to the Inquiry that the organisation had misunderstood the nature of the proposal under discussion. Accordingly the Inquiry arranged a meeting and provided further information in order to demonstrate that the Government would have no role, that the funds would not be locked up, that the funds would be paid out of the trust as soon as possible and that there would be no question of cash flow being impeded by reason of the existence of the fund.

In the submission the organisation claimed that:

“paying into a trust fund would accelerate builders going insolvent. No builders have one hundred million dollars to secure a billion dollar project.”

Later in the submission the organisation said that it remained:

⁵²⁵ It will be remembered that the Inquiry’s Discussion Paper 2012 sought detailed comments about investments during the payment cycle.

⁵²⁶ Witness to the Inquiry.

“.....sceptical with the proposal of a trust fund. Builders would still have to pay subcontractors, so paying 60% of their funds to trust funds would not work. Governments do not pay to trust funds, so it would be inequitable for companies to do so. The proposals seem to be leading down a path where builders may end up just be (sic) paid a management fee for their work, which would be completely unsatisfactory. Put simply, if there is no risk, then there is no profit. If there was no scope to make profit by builders and subcontractors, then there would be no reason to have subcontractors rather than employees. If a trust fund scheme did eventuate, then it should be operated and paid for by developers, not builders. A fund like rental bond board scheme as mentioned in (organisation) prior submission could be acceptable, subject to seeing a detailed proposal. However, (organisation) is sceptical that any “ring fenced” funds would remain “ring fenced” from future cash strapped NSW Governments.”⁵²⁷

The many misconceptions in this submission have been addressed in considerable detail at the initiative of the Inquiry.

As part of that dialogue the Inquiry explained where at each step in its submission it was under a misapprehension as to the nature of the trust fund and at the same time the Inquiry explained exactly how funds would flow through the trust fund quicker and with greater security than would otherwise be the case. In that way each of the concerns expressed have been addressed.

Together with those methods the Inquiry also prepared sets of flow charts for the information of the industry. Each of those flow charts is set out immediately following this section of the Report.

The submission made by the New South Wales Construction Agencies Insolvency Taskforce dated 6 November 6 2012

The Inquiry is particularly grateful to the New South Wales Construction Agencies Insolvency Taskforce.⁵²⁸ The Taskforce in its submission referred to its examination of the operation of project bank accounts and made a number of helpful observations which may be taken as also referring to the statutory construction trust.

The Taskforce said that:

“Particular aspects which need to be understood include:

⁵²⁷ Witness to Inquiry.

⁵²⁸ The work of which is expressly referred to in the Inquiry’s Terms of Reference and with whom the Inquiry is charged with working.

- *the administrative cost of trust accounts;*
- *whether it is practical to implement trust accounts and related administrative processes for the third tier of sub-contractors and for material suppliers;*
- *whether trust account arrangements are compatible with all forms of contracting - for example can they be effectively implemented for an alliance contract;*
- *what impact short cash-flow cycles will have on the financing of projects, particularly for principal contractors;*
- *where the project costs are increased; and*
- *the extent of any reduction of client administrative costs due to more effective and transparent payment assurances.*⁵²⁹

The Inquiry's response

Each of these questions is sound and perceptive and demands answers. The Inquiry has for the most part at least, set out evidence relating to these questions and its own view upon each question.

What also emerges clearly and helpfully from the Taskforce submission and from the way in which the Taskforce has formulated these questions, is the need for an education program not just for the industry at large in any event, but one which deals specifically with the Inquiry's recommendations. Good government practice ensures that draft legislation is given a particular exposure period and the subject of the present recommendations should be no exception. The Inquiry has also recommended that there be a significant transitional period during which those participating in the industry may bring their house into order and begin to treat moneys which are not really theirs as if they were the entitlement of others.

The Old Chestnut: "administrative difficulties, burdens and costs"

The Inquiry now returns to the question as to whether or not there is any justifiable basis for the assertions that have been made in unsupported form on behalf of some contractors (not all), to the effect that the construction trust will hamstring the industry and cause it to choke upon an indigestible amount of additional paperwork.

In order to answer that question for itself, the Inquiry approached Mr John Melliush of Ferrier Hodgson to analyse a preliminary non-binding draft of the Inquiry's

⁵²⁹ NSW Construction Agencies Insolvency Taskforce Submission, 20 November 2012, p. 15.

recommendations in this respect for the purpose of providing his view upon the question whether there is a considerable amount of additional work involved and even if so whether that was likely to have any significant or measurable impact upon the efficiency or costs structure of the industry.

The response to the Inquiry was a firm statement of opinion that he could not see any significant additional costs or effort and that even if there were additional costs incurred because of the necessity to open a separate bank account, that additional cost was not significant and for that cost there was a more than compendious benefit.

On the issue of administrative burden and cost, the view was expressed in the following way:

“There is no doubt that industry participants will claim that the introduction of such a scheme will impose an unnecessary administrative burden and increase costs. The scheme as outlined to me, in my view would impose no greater burden than would already be required in order to maintain appropriate financial records on a project by project basis. You would imagine that in costing the project a detailed budget will have been prepared, and by requiring project specific accounting, management will be able to determine that particular project remains on track, and identify at an early stage any problems or cost overruns. As mentioned above I believe there has been a lack of appropriate risk management and financial discipline which has contributed to the high number of insolvencies.”⁵³⁰

A similar view was expressed by Canadian lawyer Bruce Reynolds in a submission he made to the Inquiry:

“In my view, it is a “red-herring” to suggest that the administration of multiple trust accounts would be too burdensome for head contractors to successfully manage. Head contractors typically administer multiple project cost control systems and the requirement to add multiple bank accounts to the accounting functions of head contractors is, in reality just adding additional sets of banking documents and another layer of book-keeping, to an already sophisticated accounting environment.....I simply do not accept that head contractors cannot adapt to the incremental administrative burden.”⁵³¹

These views sought from independent and experienced practitioners in the industry confirmed and supported the Inquiry’s own view that statements made along the lines

⁵³⁰ John Melluish , Ferrier Hodgson, letter dated 6 November 2012, p 2.

⁵³¹ Bruce Reynolds, letter dated 19 November 2012.

that there was a significant administrative dead weight imposed upon the industry if the construction trust was introduced, were not supported by the evidence before the Inquiry and ought to be rejected. It should be noted that similar comments were made to the Cole Royal Commission and the Royal Commissioner, the Honourable Mr TRH Cole QC also then commented upon the absence of any specific evidence upon the subject.

Additional paperwork

The Inquiry therefore concludes that when assessing the desirability and utility of implementing the Inquiry's recommendations that the Government ought to do so in the light of the findings of the Inquiry that there is no merit in the suggestion that the sky will fall in at the same time deluging the industry with additional paperwork.

An audit of the statutory trust fund proposal

The Inquiry has concluded that it may be helpful both for a Government, its policy advisers and the Parliamentary Counsel if a priori analysis of the recommended statutory construction trust is undertaken by means of a method where one starts with nothing but a statement of the objectives of the trust. That method of analysis will be set against a context in which the subcontractor has carried out most of the work and supplied most of the materials, has submitted a progress claim to the head contractor who has included that progress claim in its progress claim to the principal and where the principal has paid the head contractor all or most of that claim and the head contractor then becomes insolvent before paying the progress claims of the subcontractors.

Leaving aside the known positions in the United States and in Canada, the exercise should commence with an attempt to draft each element of the recommended new section. Those elements are as follows:

Whenever a payment is made by an principal or by a head contractor or subcontractor which includes payment in respect of work and materials carried out and supplied by subcontractors, sub subcontractors or suppliers, then the head contractor, subcontractor or sub subcontractor as the case may be, will from the moment of receipt of those moneys hold them as trust moneys on behalf of the subcontractors or sub subcontractors or suppliers as the case may be, for the sole purpose of payment of moneys due and payable to such subcontractors, sub subcontractors or suppliers.

If each of those elements are essential to the solution to the problems under examination, then they would give rise to a form of words which is remarkably similar to the statutory formula in a number of Canadian provinces and American states.

Appendix: Relevant Extracts from the 1998 WALRC Report

Under the heading Financial Protection in the Building and Construction Industry, the Commission wrote:

3(a) A trust scheme should be introduced

3.9 One option for reform examined in the Discussion Paper was to provide statutorily that all sums received by a head contractor or subcontractor ("the trustee") on account of its contract price are trust funds in its hands for the benefit of its subcontractors, workers and suppliers ("the beneficiaries").⁵³² This imposes a fiduciary relationship on what would otherwise be a debtor-creditor relationship.⁵³³ Failure to pay a debt is not merely a breach of contract, but a potential breach of trust.

At 3.10

In some jurisdictions, the legislation goes further and provides that moneys in the hands of the owner for the purpose of the project are trust moneys. This is done by providing, for example, that where sums payable to a contractor by the owner become payable on the certificate of a person named in the contract, upon the issuance of the certificate, an amount equal to the sums so certified which is in the owner's hands or which subsequently comes into the owner's hands⁵³⁴ shall be a trust fund for the benefit of the contractor.⁵³⁵

At 3.11

Generally, in the case of a head contractor or subcontractor, trust schemes provide that a trust arises when the contract moneys are received by them. Usually this is when the moneys are in their hands but it can arise when moneys are owing to the contractor on account of the contract price even though they have not been paid to the contractor.⁵³⁶ As a result, if, for example, moneys owing to a contractor under a contract for the project are paid into court, the moneys are deemed to be impressed with the trust and must be held for the

⁵³² A trust scheme may provide that until the beneficiaries of a trust are paid for work done or materials supplied, the trustee may not appropriate trust moneys for its own use except as permitted by the statute creating the scheme.

⁵³³ A creditor/debtor relationship and a beneficiary/trustee relationship can coexist: see *Stephens Travel Service International Pty Ltd v Qantas Airways Ltd* (1988) 13 NSWLR 331, 340-341.

⁵³⁴ For example, where a payment is made to the owner by its financier.

⁵³⁵ Ont s 7(2). This legislation also provides that all sums received by an owner that are to be used in financing a project, including any amount that is to be used in the payment of the purchase price of the land and payment of prior encumbrances, constitute, subject to payment of the purchase price of the land and payment of prior encumbrances, a trust fund for the benefit of the contractor. Until the contractor is paid, the owner cannot appropriate any part of the trust to its own use: id s 7(1) and (4).

⁵³⁶ Macklem and Bristow 9-21.

benefit of the beneficiaries.⁵³⁷ It also means that any money received from the owner by the trustee in bankruptcy of the head contractor on account of the contract price is subject to the statutory trust and is not the property of the bankrupt. The money is not therefore divisible among the trustee's creditors until the beneficiaries under the trust are paid.⁵³⁸

At 3.15

Although a majority of those who commented on the issue were opposed to trusts, in view of the advantages of a trust scheme set out below, the Commission **recommends** that a trust scheme be established statutorily in the building and construction industry. A statutory trust has the following advantages:

- (1). It provides a means of ensuring that a head contractor and subcontractors are paid for their services and for materials supplied while keeping contract moneys within the control of the parties to the project.
- (2). It imposes ethical standards on the payment of participants in the industry for work done or materials supplied in an industry which has failed to use self regulation to control the use of various unfair or unscrupulous practices.³⁸
- (3). It reinforces good practice in the distribution of funds for a project to the participants in the project and is consistent with the concept of cooperative contracting, which is seen as a way of improving the efficiency of the industry.
- (4). Because the moneys are held in trust, they cannot be seized or frozen by a receiver or liquidator of the trustee or the trustee of the estate of a bankrupt trustee.³⁹ This means that the position of a person further down the chain can be secured and the payment of funds downward can still take place because the project funds held in trust will not form part of property distributed in the bankruptcy or winding up of the trustee.
- (5). A wider range of remedies is available for a breach or possible breach of trust than for a breach of contract. 6. It may result in a speedier resolution of disputes between, for example, a head contractor and a subcontractor, because generally the head contractor cannot withdraw money from the trust fund until all the claims of the fund's beneficiaries have been met. It removes the incentive for those holding funds to create artificial disputes and resolve them through purely commercial pressure.
- (7). For the same reason, it may result in speedier payment of subcontractors.

At 3.16

Trust schemes have been subject to a number of criticisms.

⁵³⁷Id 9-21 to 9-22.

⁵³⁸Id 9-23 to 9-24.

One is that they may not be simple to administer and that there may be substantial additional costs associated with administering them. The Commission is not convinced that administration will be a significant problem because the scheme it recommends be adopted in this report merely superimposes a fiduciary duty on a contractual relationship as has already been done in some standard building contracts in relation to retention funds. Additional accounting requirements will be limited to requiring each trustee to keep a trust account for project funds for each project separate from its general banking account.⁵³⁹ Doing this will not necessarily require any more stringent bookkeeping than is now required for the proper running of a business or to comply with taxation laws. Even if there were increased costs they are likely to be offset by the interest received on the trust moneys while they are held in trust. Further, any additional accounting costs are unlikely to increase the cost of building because those costs are likely to be more than offset by a more secure payment system which will do away with or reduce the need to build into the contract price a sum to cover defaults or delays in payment.⁵⁴⁰

The New South Wales Security of Payment Committee claims that conservative estimates of cost savings of a more secure payment system are five per cent of current gross project costs. It argues that this can be demonstrated by the tender price reductions for direct payments from government on building contracts as compared to project costs on private contracts. This difference exists because default costs and late payment costs are built into the industry's pricing structure for private contracts but not for government contracts. If the risks are reduced or eliminated, the competitive nature of the industry should eliminate the built in pricing factor for default or delay in payment. For those with credit indemnity insurance, a more secure payment system is likely to result in lower premium rates or a reduction in the sum insured with a consequent reduction in premiums.

At 3.17

A second concern with a trust scheme is that it is effective only to the extent that there is trust property available to meet the claims of beneficiaries:

"It does not guarantee payment where, for example, the contractor or subcontractor has underbid a job or where the right of set-off arises because of an incomplete or deficient job. In the situation of underbidding or of set-off, it is conceivable that a trust beneficiary will

⁵³⁹Para 3.32 below. A consolidated trust account could be kept in prescribed circumstances: para 3.34 below.

⁵⁴⁰The Andersen Report concluded from data collected by the New South Wales Royal Commission Into the Building Industry that "the combined impact of late payment and payment default...equals 2.84% of total subcontractor turnover".

not be paid in full even though there has been no breach of trust anywhere in the chain. As long as a trustee pays all trust money he receives, he discharges his obligation even though his beneficiary is not paid in full."⁵⁴¹

A trust scheme might, however, deter underbidding or underquoting for two reasons. First, it would be a breach of trust for trust funds from one project to be used to meet financial obligations on another project. It would therefore no longer be desirable to underbid on one project to obtain a cash flow to meet payments on another project.⁵⁴² Secondly, if there were insufficient funds available in the trust to pay all beneficiaries, the funds would have to be distributed on a pro rata basis to the beneficiaries.⁵⁴³ The head contractor would not be entitled to any of the trust fund. It therefore would not be in the head contractor's interest to underbid or underquote for a project. Contractors could, however, cover themselves for any shortfall by credit indemnity insurance. So far as set-off is concerned, the reduction of trust funds by a set-off or counterclaim will be limited because the Commission recommends below⁵⁴⁴ that only a party to a project should be entitled to a set-off and that party should be a beneficiary of the trust to the extent of the sum the debtor is entitled to receive from the fund. If the fund were insolvent, the trust monies would be distributed on a pro rata basis amongst the beneficiaries. While this would discharge the trustee's obligations under the trust, it would not discharge its obligations under the contract and action could be taken to recover any outstanding sum under the contract.

At 3.18

A third concern is that one consequence of a trust scheme is that it will reduce the scope for contractors, particularly head contractors, to divert money received for one project to meet payments on another project. To the extent that this occurs at present, it will be necessary to secure other funds to meet the payments on other projects. A trust scheme will not completely deny a builder the opportunity of using funds due to him on one project on another project because a trustee will still be able to withdraw funds from the trust in some circumstances, for instance, where the trust account balance exceeds the moneys owing to the beneficiaries of the trust.⁵⁴⁵ In any case, the Commission considers it to be fair that funds cannot be diverted from one project to another. It is merely good business practice and good corporate governance to ensure that

⁵⁴¹Ettinger 393.

⁵⁴²This was one undesirable practice referred to above: para 1.8.

⁵⁴³Para 3.47 below.

⁵⁴⁴Para 3.41.

⁵⁴⁵Para 3.35 below. See also paras 3.36-3.43 below.

adequate funding is available for a project without recourse to funds properly due to another contractor on another project and without putting those funds at risk by using them on the project. It would also discourage individuals or corporations which are under capitalised from operating on the basis of "free" capital supplied by others lower in the contractual chain.

At 3.19

According to an opinion prepared for the New South Wales Security of Payment Committee the prevention of the diversion of funds from one project to another project was seen as a strength of the trust approach by the Australian Banking Association and the Australian Finance Conference. Both endorsed the trust approach on the basis that it would ensure that funds made available for a project actually went into the project thereby preserving the value of and enhancing the security taken by the financier over the project.

At 3.20

A fourth concern with a trust scheme is that those higher up the contractual chain may attempt to evade a trust scheme by adopting a residence or domicile or obtaining finance outside the State. However, the State Parliament can enact laws having extraterritorial operation,⁵⁴⁶ that is, laws which affect persons, conduct or things outside the State, so long as the law has a sufficient connection with the State.⁵⁴⁷ There might also be concern that a trust scheme would breach section 92 of the *Commonwealth Constitution* which provides that "trade, commerce, and intercourse among the States....shall be absolutely free". The Commission's position is that this is not the case because a trust scheme would not impose government controls or burdens which discriminate against interstate trade and commerce so as to protect intrastate trade against competition. Nor are government controls to resolve problems, which are not designed to protect intrastate trade against interstate competition, invalid if they are "...appropriate

⁵⁴⁶ *Australia Act 1986* (Cth) s 2(1). This may be contrasted with the position in Canada where, prima facie, provincial statutes do not have extraterritorial operation: *Horsman Bros Holdings Ltd v Sigurdson* (1979) 104 DLR (3d) 458, 462.

⁵⁴⁷ See generally 5 *Halsbury's Laws of Australia* [90-1215], R D Lumb *The Constitutions of the Australian States* 5th edn (St Lucia. Qld: Uni of Qld Press, 1991) 86-89; P H Lane *An Introduction to the Australian Constitutions* 6th edn (Sydney: Law Book Co, 1994) 209-210; and Peter Hanks *Constitutional Law in Australia* 2nd edn (Sydney: Butterworths, 1996) 216- 224.

If the recommendation for a trust scheme were adopted, the legislation could contain a provision dealing with the application of the rules for choice of law: see eg *Bills of Exchange Act 1909* (Cth) s 77. It might be desirable to provide that all matters relating to the trust, including the personal liability of the trustee to the beneficiaries and the duty of the trustee to account for its administration of the trust, be governed by the law of the forum, which in most cases is likely to be Western Australia.

and adapted to the resolution of those problems [and if] any burden imposed on interstate trade was incidental and not disproportionate to their achievement".⁵⁴⁸

At 3.21

A fifth concern with a trust scheme is that third parties may become involved. This concern arises because the law of trusts provides powers relating to the tracing of funds. However, trust funds can be traced and recovered only if they come into the hands of a third party who is not a bona fide purchaser for value without notice of the breach of trust.⁵⁴⁹ Otherwise the beneficiary may recover the trust monies or any other property into which the money has been converted or obtain a charge on the trust money or its traceable product. As notice of the breach may be constructive those dealing with trustees in legitimate business dealings, such as banks which hold trust funds, need to confirm that payments from trust funds to them, for example to reduce an overdraft or under an assignment of accounts receivable, are in accordance with the trust. If they are, they are free from fund tracing actions by beneficiaries of the trust. Canadian cases suggest that if a bank is aware that a customer is a head contractor or subcontractor and funds deposited in its account are the proceeds of building contracts, the bank is taken to have notice that the relevant legislation impresses the funds with a trust to the extent that; there are unpaid beneficiaries.⁵⁵⁰ Where banks are aware that funds deposited with them are trust monies they can avoid being subject to tracing actions by ensuring that the beneficiaries have been paid before receiving payments from their customer.

At 3.22

A sixth concern with a trust scheme is that it interferes with the application of the insolvency laws and the priorities for the distribution of a debtor's assets to its creditors because trust funds payable to participants in a project do not form part of the debtor's estate for distribution to the debtor's creditors. However, this interference can be justified because if it were not the case, creditors other than participants in the project would obtain a benefit from the work and materials supplied by the participants for which they had not been paid. Where the insolvent debtor is the owner of the building, the building will be an asset of the estate which can be used to satisfy the claims of its other creditors. Where the insolvent debtor is one of the other participants in the project, any trust money paid to the debtor which it is entitled to retain for work done or materials it

⁵⁴⁸ *Castlemaine Tooheys Ltd v South Australia* (1990) 169 CLR 436, 473. See also *Cole v Whitfield* (1988) 165 CLR 360.

⁵⁴⁹ H A J Ford and W A Lee *Principles of the Law of Trusts* 3rd edn (Sydney: Law Book Co, 1996) para [17170].

⁵⁵⁰ Ettinger 422.

supplied will become an asset of its estate which can be used to satisfy the claims of its creditors.

At 3.23

...The Commission does not favour this approach because it is likely to be expensive and create a large bureaucracy.⁵⁵¹ Accordingly, the Commission **recommends** that the responsibility of being the trustee should not be given to a government body but that the trustee should be permitted to be one of the participants in the construction project.⁵⁵²

At 3.24

...To provide maximum protection for the head contractor and others involved with a project, where the owner provides its own capital, the Commission **recommends** that moneys in the hand... of the owner to pay for, or funds received by the owner or earmarked by the owner to pay for, the improvements should be held in trust for the benefit of the head contractor.⁵⁵³

At 3.25

Part or all of the funds to pay the head contractor under the contract might come, not from the owner's own resources, but from a financier and those funds might be secured by a mortgage or other security. In these circumstances, the Commission **recommends** that all amounts received by the owner or advanced by a financier⁵⁵⁴ that are to be used in financing the improvement should be held in trust for the benefit of the head contractor.⁵⁵⁵ That is, a trust would arise in

⁵⁵¹The use of a government body was rejected by the Smith Report in 1974 because it would be an "administrative nightmare": para 7.36.

⁵⁵²The trustee should be free to appoint a person, including a trustee corporation, to be the trustee in its place: *Trustees Act 1962* s 7(1). That trustee, no doubt, would need to be paid a fee and have its expenses reimbursed by the person who appointed it.

⁵⁵³This would include -

- (a) any funds of the owner that he identifies to the head contractor as funds to be used for payment of the improvement, including rental income;
- (b) any funds received by one owner from another owner that are to be used as payment for the improvement;
- (c) where the owner's interest in the improvement is sold before the full sum due to the head contractor has been paid, a portion of the proceeds of the sale equal to the sum outstanding to the head contractor.

As is the case in Saskatchewan, it may be necessary to provide that where the consideration in a contract does not consist of money, the value of the part of the consideration that does not consist of money is deemed to be money for the benefit of the beneficiaries of the trust: Sask s 10. It may also be necessary to make express provision for the manner in which the proceeds of an insurance policy are to be distributed where an improvement is wholly or partly destroyed: see Sask s 9.

⁵⁵⁴Usually funds are advanced directly to the head contractor by the financier as each progress payment falls due.

⁵⁵⁵See Sask s 6(1).

relation to the funds at the time the financier is required to advance the funds to enable the owner to meet a progress payment or final payment to the head contractor. This recommendation is also intended to avoid the difficulties referred to in the previous paragraph. Where an owner is a trustee of funds in the manner recommended in this and the previous paragraph, the owner should not appropriate or convert any part of the trust monies to its own use or to any use inconsistent with the trust until the head contractor is paid all amounts related to the improvements payable to it under the contract.⁵⁵⁶

At 3.27

Each participant who is under an obligation to another participant of a project should be a trustee

...Having recommended that the trustee should be one of the participants in the construction project, rather than a government body, the question arises whether there should be a single trustee for a project or whether each participant in a project who is under an obligation to pay another participant should be a trustee. The first approach has been proposed in New South Wales where it was suggested that the head contractor should be the trustee.

At 3.28

The "privity of trust" approach should not be adopted

...In some Canadian provinces each trustee is required to hold funds in trust only for those with which it has contracted directly (known as the "privity of trust" approach). In other provinces each trustee is required to hold funds for all those down the chain from it.⁵⁵⁷ The Commission **recommends** that the second of these approaches be adopted because it has the advantage that those further

In Ontario all amounts received by an owner that are to be used in the financing of the project constitute a trust fund for the benefit of the head contractor; Ont s 7(1). A similar trust arises where an amount becomes payable by the owner on a certificate of payment (Ont s 7(2)) or where substantial performance of a contract has been certified: Ont s 7(3). See also Man s 5(1)-(2).

In Ontario the owner discharges its obligations under the trust when it pays to the contractor the amount certified for payment: Ont s 10.

⁵⁵⁶See Sask s 6(4).

⁵⁵⁷This approach has been adopted in New Brunswick and British Columbia. In British Columbia, for example, s 2(1) and (2) of the *Builders Lien Act RSBC 1996 c 41* provide:

"(1) All sums received by a contractor or subcontractor on account of the contract price are and constitute a trust fund in the hands of the contractor or of the subcontractor, as the case may be, for the benefit of the owner, contractor, subcontractor, Workers' Compensation Board, workers and material suppliers.

(2) The contractor or the subcontractor, as the case may be, is the trustee of all those sums received by the contractor or subcontractor on account of the contract price, and, until all workers and all material suppliers and all subcontractors are paid for work done or material supplied on the contract and the Workers' Compensation Board is paid any assessment with respect to those sums, must not appropriate or convert any part of it to the contractor's or subcontractor's own use, or to any use not authorized by the trust."

down the chain have greater protection. They can obtain trust money directly when there is a problem with a contractor higher in the chain or they can attempt to prevent a breach of trust. It is true that the first approach, the privity of trust approach, has two advantages -

1. It is simple. The trustee knows that the beneficiaries are those with which it has contractual privity.
2. It maintains an orderly flow of funds down the chain.⁵⁵⁸

At 3.30

...The second issue is what should the trustee be required to do to discharge its obligations to the beneficiaries. In Canada, a trustee's obligations to the beneficiaries are fully discharged when the trustee has paid in full the parties with whom it contracted.⁵⁵⁹ This means, for example, that an unpaid supplier of a subcontractor is not entitled to be paid from any contract moneys in the hands of the head contractor if the head contractor has already paid the subcontractor all moneys due and owing to it. When the trust is insolvent, the trustee can discharge its obligations to the beneficiaries by distributing the funds on a pro rata basis.⁵⁶⁰

The Commission **recommends** that this approach be adopted in Western Australia.

At 3.32

The trustee should be required to keep a separate trust account

...To promote the effectiveness of a trust scheme, the Commission **recommends** that a trustee, including an owner building his own home, should be required to keep trust funds in a trust account, separate from its general banking account.⁵⁶¹ Otherwise, the trust funds could become mixed with other money and therefore be unidentifiable. A requirement for a separate trust account will:

"...effectively eliminate a problem encountered in [Canadian Provinces] where a contractor pays trust money into his general account and his bank takes the money to cover the contractor's previous indebtedness to the bank. As long as the bank did not have notice, actual or constructive,

⁵⁵⁸Ettinger 416.

⁵⁵⁹Ettinger 412.

⁵⁶⁰Para 3.47 below.

⁵⁶¹To reduce the costs associated with keeping separate trust accounts, trust accounts could be made exempt from financial institutions duty and debits tax. Prescribed trust accounts required to be kept under a prescribed Act can, for example, be exempt from financial institutions duty: see *Financial Institutions Duty Act 1983* ss 15 and 10(4)(a).

that the funds were subject to a trust, the bank is entitled to the moneys."⁵⁶²

At 3.34

Another question raised in the Discussion Paper was whether the trustee should be required to keep a consolidated trust account, that is, one account into which all trust moneys in respect of all projects should be paid, or a separate trust account for each project. In Canada it has been held that if accounts have been mingled, so that a number of subcontractors from different projects can trace moneys to that one mingled account, they are all on an equal footing and are entitled to payment out of the account rateably. If, however, the moneys are clearly identifiable and traceable to one of the projects, the recovered sum is deemed to be impressed with a trust in favour of the subcontractors of that project.⁵⁶³ Clearly it is desirable to ensure that moneys from different projects are not mingled. However, some contractors' accounting standards may not be adequate to ensure that funds can be identified as belonging to particular projects. To ensure that moneys from different projects are not mingled, the Commission **recommends** that trustees (whether an owner building his own home, a contractor or a subcontractor) should be required to open a separate trust account for each project. However, trustees should have the option of using a single consolidated trust account with the approval of the Builders' Registration Board if they can demonstrate that they can maintain books of account of all trust moneys received, deposited or disbursed in such a manner as to disclose the true position as regards those moneys in relation to particular projects and to enable the books to be readily and conveniently audited. If this option is taken, the account should be audited annually.

At 3.35

Withdrawal of money from the trust fund by the trustee

...An important issue with a trust scheme is determining when a trustee can draw funds owing to it from the trust fund. One option is to allow a trustee who is the head contractor or a subcontractor to withdraw the balance of the trust funds when the project is completed, so long as all obligations to its beneficiaries have been met.⁵⁶⁴ However, while this option should be available,

⁵⁶²Ettinger 398. Many cases in Canada deal with the question of whether or not the bank was aware of the nature of the funds. A statutory trust itself does not constitute notice of a trust: Macklem and Bristow 9-28. If a bank is aware that the funds are trust funds, the bank is a participant in a breach of trust which makes it liable to the beneficiaries. In any case, the trustee is in breach of the trust for failing to preserve trust assets. If the trustee is a corporation, its officers and directors who are its operating mind will be personally liable; id 9-52.

⁵⁶³Macklem and Bristow 9-15.

⁵⁶⁴In this case, the trustee would receive the balance of the fund including any interest which had accrued on the money held in trust.

the Commission **recommends** that a trustee should be able to withdraw money from a trust fund before a project is completed so long as there is sufficient money left in the fund to pay the beneficiaries the moneys owing to them in full. This would enable the trustee to withdraw funds to meet its own overheads or profit. To provide otherwise could cause financial hardship to trustees, particularly on projects which extended over a long period of time.

At 3.36

In some circumstances the trustee might pay for materials, service, labour or rented equipment for the project out of its own funds. In these cases the Commission considers that it is fair to allow a withdrawal from the trust fund of an amount equal to the sum paid and **recommends** that such a withdrawal should not constitute a breach of trust so long as the fund is not insolvent or rendered insolvent as a result of the withdrawal.⁵⁶⁵ Where a fund is insolvent, the Commission recommends below that the moneys in the fund should be distributed to the beneficiaries on a pro rata basis.⁵⁶⁶

At 3.40

A right to recoup moneys from the trust fund for a set-off or counterclaim goes beyond allowing a trustee to reimburse itself from trust funds for sums paid out of its own funds or to repay a lender when the borrowed funds were used to pay trust beneficiaries. Reimbursement does not reduce funds flowing down the chain. Recoupment, particularly for set-off or counterclaims relating to other projects, is likely to result in a reduction in funds flowing down the chain. This could occur even if recoupment were confined to a set-off or counterclaim related to the project for which the trust fund was created. If a contractor or subcontractor abandoned a contract relating to the project, the costs of completing the project or damages resulting from delayed completion might increase the cost of the project to the owner. A recoupment by the owner from the head contractor of any increased costs would reduce the funds flowing down the construction chain.

At 3.43

In some cases a trust fund might be insolvent because O has not paid HC the total sum due to it.⁵⁶⁷ Suppose HC is under an obligation to pay \$90,000 to its subcontractors but due, for example, to the insolvency of O, it has received only \$80,000 from O. In this case the trust fund of \$80,000 would be distributed amongst the beneficiaries on a pro rata basis.⁵⁶⁸ HC could not withdraw any

⁵⁶⁵This is the case, for example, in Ontario: Ont s.11(1).

⁵⁶⁶Para 3.47.

⁵⁶⁷And so on down the chain.

⁵⁶⁸Para 3.47 below.

sum from the fund. However, if HC were entitled to a set-off or counterclaim against one of its subcontractors it would be a beneficiary of the trust but only to the extent of the sum that that subcontractor was entitled to receive from the pro rata distribution of the trust and after payment of its subcontractors and suppliers.

At 3.44

Adoption of the recommendation in this section would not prevent the creation of retention funds so long as they are trust funds.⁵⁶⁹ These funds are created to enable head contractors and subcontractors to provide security to the amount or percentage set out in the contract for the due performance of their obligations under the contract.⁵⁷⁰

At 3.45

Distribution of trust funds to the beneficiaries

...The timing of payments by a trustee to the beneficiaries of the trust fund is important. If a trustee were required to maintain an even hand, it would not be possible to make progress payments to subcontractors in case the fund became insolvent. In Canada, a trustee is not required to maintain an even hand among the beneficiaries, at least where the claims of the beneficiaries do not exceed the amount available for distribution.⁵⁷¹ The reason for this is that:

"...contractors must be able to pay their subcontractors and suppliers as the work proceeds and not be in breach of the trust even if some beneficiaries end up not being paid in full. As long as the contractor has paid out all the trust funds to trust beneficiaries, he will have discharged his trust obligations. The alternative would be for the contractor to withhold payment from all beneficiaries until the end of construction when he could be sure of ascertaining all the beneficiaries and their pro-rata portion. This would be a commercially unacceptable impediment to the flow of funds, and one would assume, contrary to the intent of the legislation."⁵⁷²

In Canada it has been held that where trust funds are paid to a beneficiary of the trust, the beneficiary cannot apply the funds, the subject of a trust of which it has notice, to a purpose outside the trust such as to the payment of an earlier account relating to another project.⁵⁷³ As the fund is being distributed on equitable

⁵⁶⁹ See the recommendation in para 3.91 below.

⁵⁷⁰ See, eg, SC.JCC.A 1985 cls 10.21-10.26.

⁵⁷¹ See Ettinger 403-405 and Ont s 10.

⁵⁷² Ettinger 404.

⁵⁷³ *Standard Prestressed Structures Ltd v Bank of Montreal* (1968) 69 DLR (2d) 183, 193-194.

principles, it would be inequitable to allow a beneficiary, having received a payment from the trust fund, to apply it on an earlier project's account, and then to claim against the fund, without giving credit for that payment.⁵⁷⁴

At 3.46

The Commission considers that the rules in Canada relating to the timing of the payment to beneficiaries of the trust should be adopted in Western Australia. This is because otherwise there would be a significant departure from the existing practice which usually involves progress payments being made as a project proceeds to completion, and not a single payment when a project is completed or when a subcontractor completes its work. Accordingly, the Commission **recommends** that, where a trust fund is solvent, the trustee should be allowed to make payments to beneficiaries of the trust as they fall due.

At 3.47

Cases may arise in which the trust fund is insolvent⁵⁷⁵ so that there are insufficient funds to satisfy the claims of all the beneficiaries of the trust. In these cases, the Commission considers that the fairest approach is to require that the trust funds be distributed amongst the trust's beneficiaries on a pro rata basis. It **recommends** accordingly. This recommendation is consistent with rules of equity under which impartiality between the beneficiaries is the guiding principle.⁵⁷⁶ It is a logical, just and workable rule.⁵⁷⁷ Such a distribution would not relieve the trustee of liability to a beneficiary for the balance of the outstanding claim.

⁵⁷⁴ Ibid 194.

⁵⁷⁵ See *Guarantee Trust Co of Canada v Beaumont* [1967] 1 OR 479 (CA) referred to in Macklem and Bristow 9-57-9.58 in which it was held that a trust fund must be distributed rateably ". . .once the builder had abandoned the project...because, although he had not been formally declared a bankrupt, he was in fact insolvent."

⁵⁷⁶ R P Meagher and W M C Gummow *Jacobs' Law of Trusts in Australia* 6th edn (Sydney: Butterworths, 1997) para 1901. See also Ettinger 404.

⁵⁷⁷ Unlike the Clayton's case rule, which allocates funds in an account on a "first in - first out" basis: see *Re Eastern Capital Futures Ltd (in liquidation)* [1989] BCLC 371 and *Re Ontario Securities Commission and Greymac Credit Corporation* (1986) 30 DLR (4th) 1.

Operational diagrams of the statutory construction trust

A series of diagrams illustrating how the statutory construction trust works in different scenarios that were the subject of frequent questions and discussions with the Inquiry, follow over the next several pages. The diagrams show the flow of funds in and of the trust fund where:

- A. Head contractor and subcontractor - no dispute and no insolvency;
- B. Subcontractor and sub subcontractor – no dispute and no insolvency;
- C. Owner and head contractor – adjudication;
- D. Insufficient money in the trust fund;
- E. If all subcontractors claims are made on the same day;
- F. Insolvency – with and without dispute.

The last diagram shows the flow of money under the current law and then the flow of money under the Statutory Construction Trust Proposal.

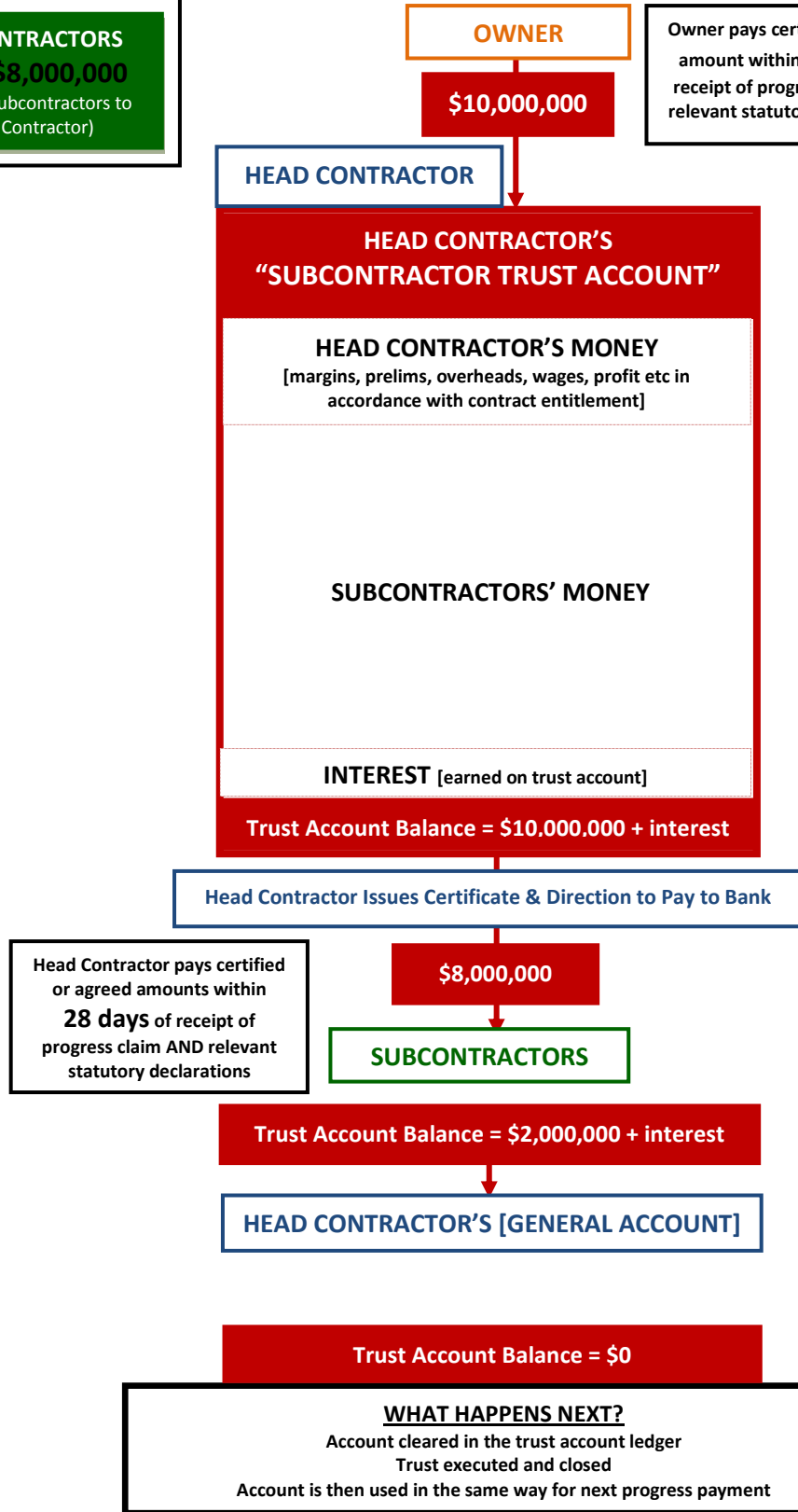
PROGRESS PAYMENT CLAIMS

HEAD CONTRACTOR
\$10,000,000
 (Head Contractor to Owner)

SUBCONTRACTORS
Total \$8,000,000
 (Various Subcontractors to Head Contractor)

STATUTORY CONSTRUCTION TRUST

**(A) HEAD CONTRACTOR AND SUBCONTRACTOR
 (NO DISPUTE – NO INSOLVENCY BASIS)**



HOW DOES IT AFFECT YOU?

AS OWNER

- *Owner pays \$10,000,000 to head contractor within **15 days** of receipt of progress payment claim (pay by electronic transfer / cheque)
- ***OWNER NOT CONCERNED WITH TRUST FUND**

AS HEAD CONTRACTOR

- *Money is trust property from the moment the Head Contractor receives it (electronic transfer or cheque) (chose in action)
- ***Whole of \$10,000,000 progress payment paid is TRUST PROPERTY (money in account)**
- *Head Contractor needs to set up one trust account for all projects – payments made to each subcontractor are maintained by ledgers in the trust account (same system as that used by travel agents, real estate agents, solicitors etc)
- *Head Contractor must issue Certificate & Direction to Pay to Bank
- *Head Contractor pays certified amounts within **28 days** of receipt of progress payment claims from Subcontractors
- *After Subcontractors are paid, Head Contractor is entitled to \$2,000,000 plus interest earned, free of the trust.

AS SUBCONTRACTOR

- *Subcontractors to be paid certified amounts within **28 days** of head contractor receiving progress payment claim

AS BANK

- *On notice that \$10,000,000 is "TRUST PROPERTY" – held in a "trust account"
- *Cannot pay out of account until receive Certificate and Direction to Pay

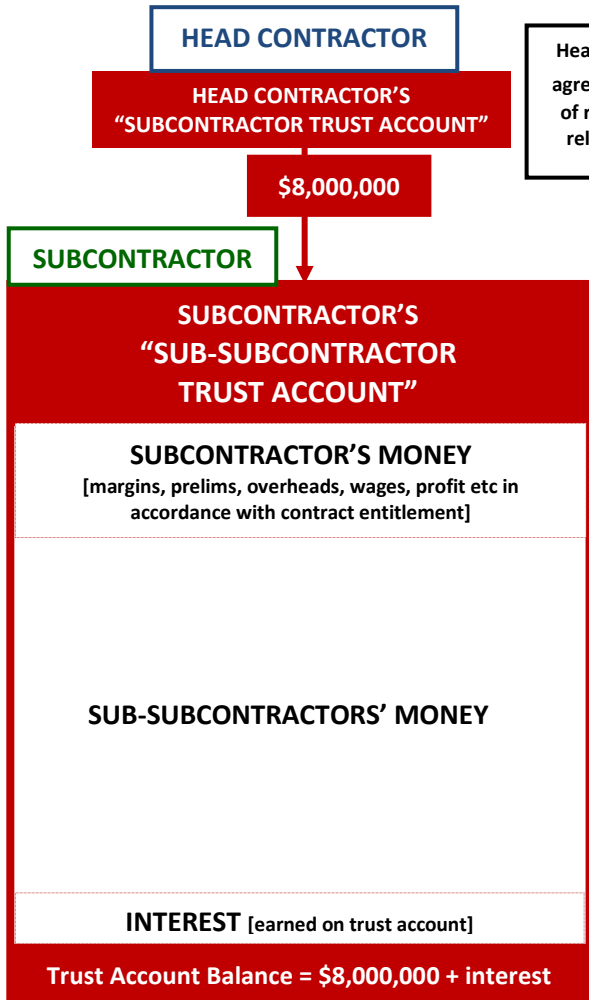
STATUTORY CONSTRUCTION TRUST

(B) SUBCONTRACTOR AND SUB-SUBCONTRACTOR (NO DISPUTE – NO INSOLVENCY BASIS) Tier 2 of Illustration (A)

PROGRESS PAYMENT CLAIMS

SUBCONTRACTORS
\$8,000,000
(Subcontractor to Head Contractor)

SUB-SUBCONTRACTORS
Total of \$7,000,000
(Various Sub-Subcontractors to Sub-Contractor)



Head Contractor pays certified or agreed amounts within **28 days** of receipt of progress claim AND relevant statutory declarations

HOW DOES IT AFFECT YOU?

AS SUBCONTRACTOR

- *Money is trust property from the moment the Subcontractor receives it (electronic transfer or cheque) (chose in action)
- ***Whole of \$8,000,000 progress payment paid is TRUST PROPERTY (money in account)**
- *Subcontractor needs to set up one trust account for all projects – payments made to each Sub-Subcontractor are maintained by ledgers in the trust account (same system as that used by travel agents, real estate agents, solicitors etc)
- *Subcontractor must issue Certificate & Direction to Pay to Bank
- *Subcontractor pays certified or agreed amounts within **28 days** of receipt of progress payment claims from Sub-Subcontractors
- *After Sub-Subcontractors are paid, Subcontractor is entitled to \$1,000,000 plus interest earned, free of the trust.

AS SUB-SUBCONTRACTOR

- *Sub-Subcontractors to be paid certified or agreed amounts within **28 days** of Subcontractor receiving progress payment

AS BANK

- *On notice that \$8,000,000 is "TRUST PROPERTY" – held in a "trust account"
- *Cannot pay out of account until receive Certificate and Direction to Pay

Subcontractor Issues Certificate & Direction to Pay to Bank

Subcontractor pays certified or agreed amounts within **28 days** of receipt of progress claim AND relevant statutory declarations



Trust Account Balance = \$1,000,000 + interest

SUBCONTRACTOR'S [GENERAL ACCOUNT]

Trust Account Balance = \$0

WHAT HAPPENS NEXT?
 Account cleared in the trust account ledger
 Trust executed and closed
 Account is then used in the same way for next progress payment

REMEMBER: The trust account does not add, take away or freeze moneys. No amount is payable into the trust account unless it contains moneys - (I) certified, (II) agreed or (III) determined - as owing to subcontractors.

STATUTORY CONSTRUCTION TRUST

(C) OWNER AND HEAD CONTRACTOR (DISPUTE – ADJUDICATION 100% WIN - NO INSOLVENCY)

LEVEL 1: OWNER & HEAD CONTRACTOR

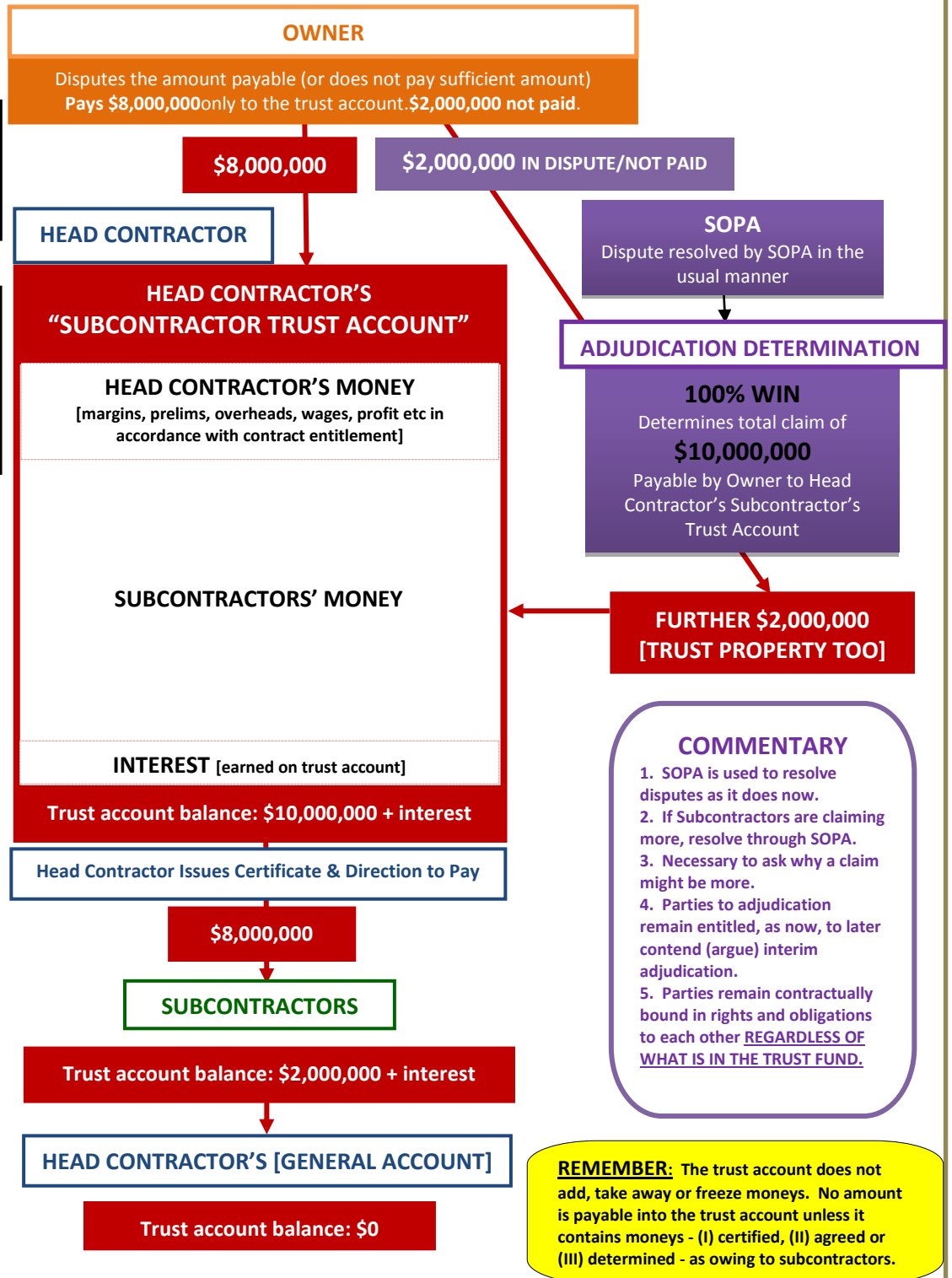
PROGRESS PAYMENT CLAIMS

HEAD CONTRACTOR
\$10,000,000
(Head Contractor to Owner)

SUBCONTRACTORS
Total \$8,000,000
(Various Subcontractors to Head Contractor)

Owner pays **UNDISPUTED** amount within **15 days** of receipt of progress claim AND relevant statutory declarations

Head Contractor pays certified amounts within **28 days** of receipt of progress claim AND relevant statutory declarations. Additional moneys from SOPA paid out as soon as adjudication completed.



LEVEL 2: DISPUTE BETWEEN SUBCONTRACTORS AND HEAD CONTRACTOR: Again resolved by SOPA in the usual manner

STATUTORY CONSTRUCTION TRUST

(D) INSUFFICIENT MONEY IN THE TRUST FUND (DISPUTE – ADJUDICATION PARTIAL WIN - NO INSOLVENCY)

LEVEL 1: DISPUTE BETWEEN OWNER & HEAD CONTRACTOR

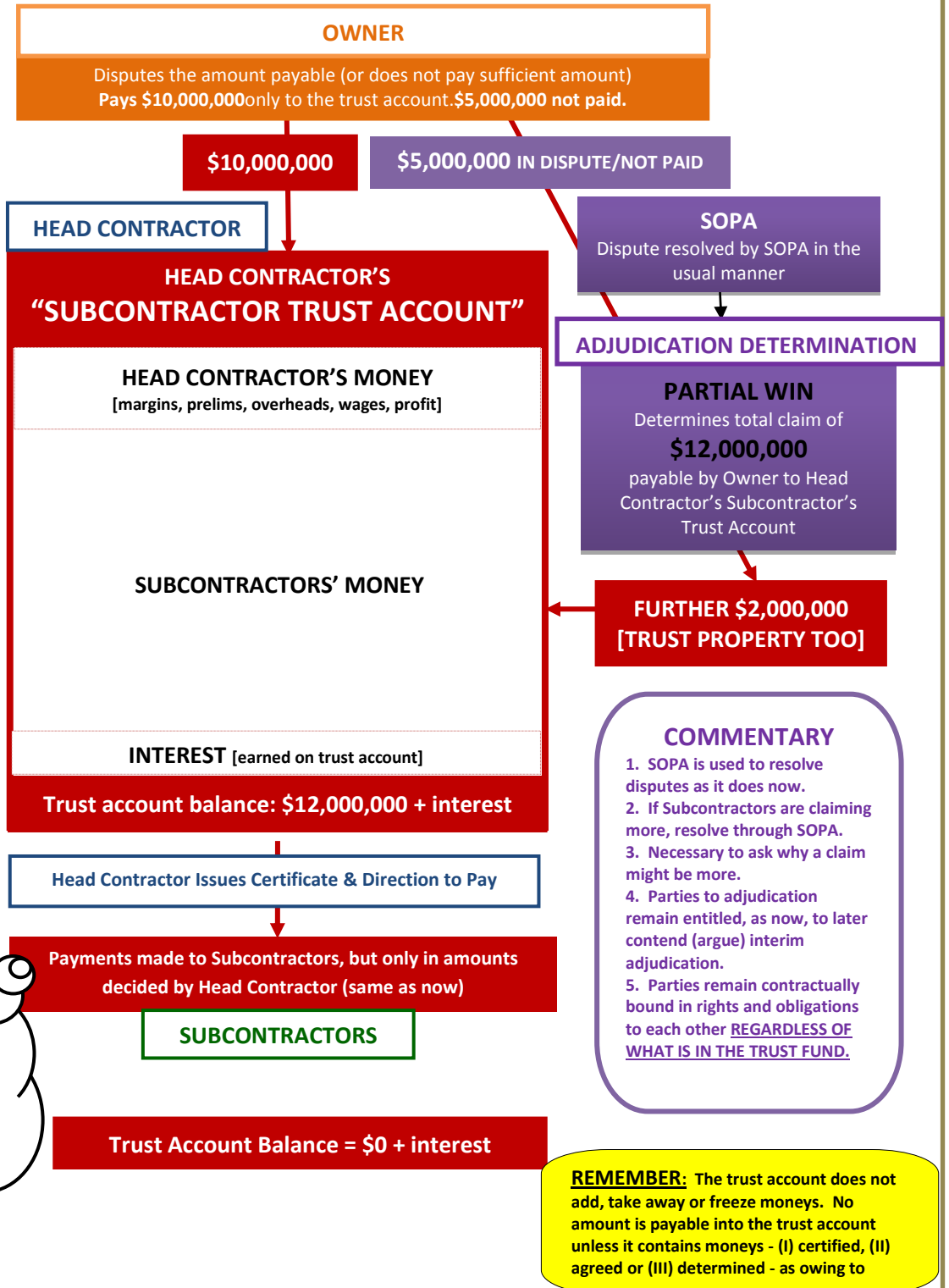
PROGRESS PAYMENT CLAIMS

HEAD CONTRACTOR
\$15,000,000
(Head Contractor to Owner)

SUBCONTRACTORS
Total of \$13,000,000
(Various Subcontractors to Head Contractor)

Owner pays **UNDISPUTED** amount within **15 days** of receipt of progress claim AND relevant statutory declarations

Head Contractor pays certified amounts within **28 days** of receipt of progress claim AND relevant statutory declarations. Additional moneys from SOPA paid out as soon as adjudication completed.



What if there is **NOT ENOUGH MONEY** in the Subcontractors' trust Account to pay all Subcontractors and then also the Head Contractor's share?
SEE ILLUSTRATION (E)

LEVEL 2: DISPUTE BETWEEN SUBCONTRACTORS AND HEAD CONTRACTOR Again resolved by SOPA in the usual manner

STATUTORY CONSTRUCTION TRUST

**(E) IF ALL SUBCONTRACTORS' CLAIMS ARE CLAIMED ON THE SAME DAY
AND...
THERE IS NOT ENOUGH IN THE ACCOUNT
(WITHOUT AND WITH DISPUTE)**

FOR EXAMPLE:

**HEAD CONTRACTOR'S
"SUBCONTRACTOR TRUST ACCOUNT"**
Trust Account Balance = \$12,000,000 + interest

BUT

**SUBCONTRACTORS PROGRESS CLAIMS
Total \$13,000,000**
(Various Subcontractors to Head Contractor)

**THE TRUST ACCOUNT FALLS SHORT
\$1,000,000 IN AMOUNT OWING TO
SUBCONTRACTORS -
WHAT TO DO?**

ANSWER: EQUITY IS EQUALITY

- * If there is not enough money in the fund, money available is paid rateably in payment to Subcontractors and the Head Contractor continues to owe the balance.
- * Head Contractor has no right to prefer one interest over the other for any reason, nor its own interest over the beneficiaries
- * If further moneys come into the trust account following a SOPA adjudication (determined in favour of the Head Contractor) then that money is to be distributed accordingly.

COMMENTARY

1. SOPA is used to resolve disputes as it does now.
2. If Subcontractors are claiming more, resolve through SOPA.
3. Necessary to ask why a claim might be more.
4. Parties to adjudication remain entitled, as now, to later contend (argue) interim adjudication.
5. Parties remain contractually bound in rights and obligations to each other REGARDLESS OF WHAT IS IN THE TRUST FUND.

STATUTORY CONSTRUCTION TRUST

(F) **INSOLVENCY** (WITHOUT AND WITH DISPUTE)

OWNER

1 JANUARY 2013
Owner pays certified or agreed amount within 15 days of receipt of head contractor's progress payment claim AND relevant statutory declarations

\$ABC

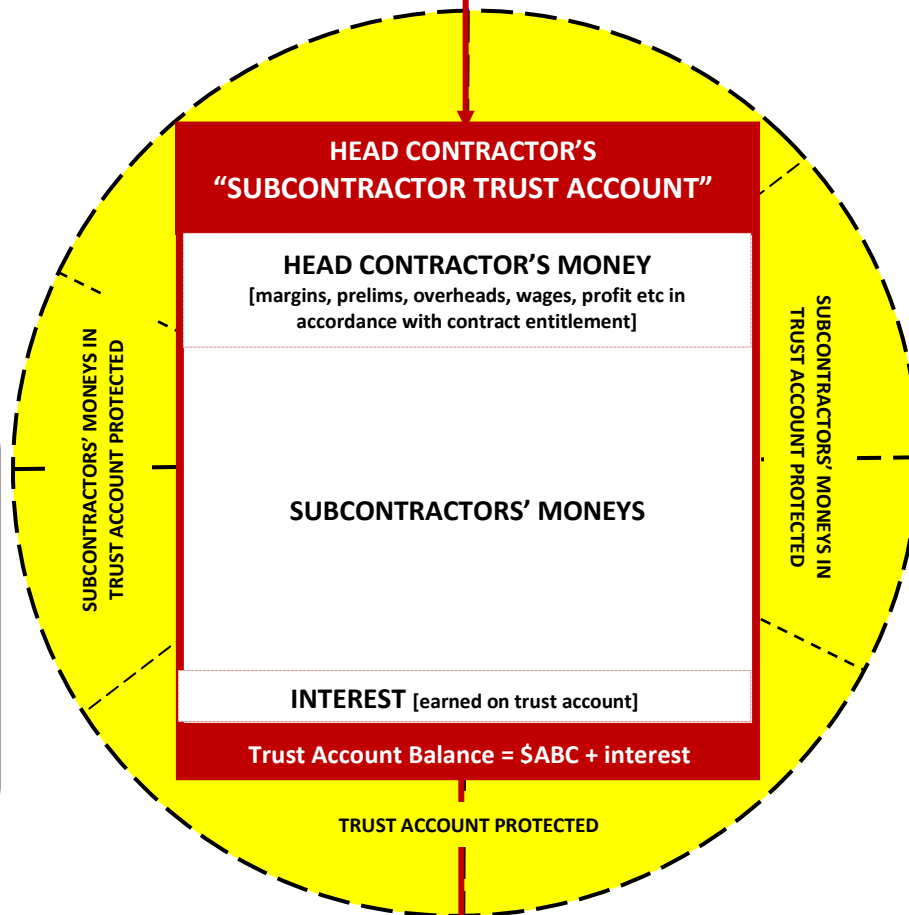
1 FEBRUARY 2013
HEAD CONTRACTOR BECOMES INSOLVENT

QUESTION:
Who sorts out the validity of the Subcontractors' claims when the Head Contractor goes into liquidation?

ANSWER:
1. Appoint new trustee.
2. Give SOPA power to resolve by simple amendment to add "trustee" in appropriate way

NEW TRUSTEE APPOINTED

Chamber Application to Supreme Court to appoint new Trustee to disburse trust funds to beneficiaries



New Trustee Issues Certificate & Direction to Pay to Bank

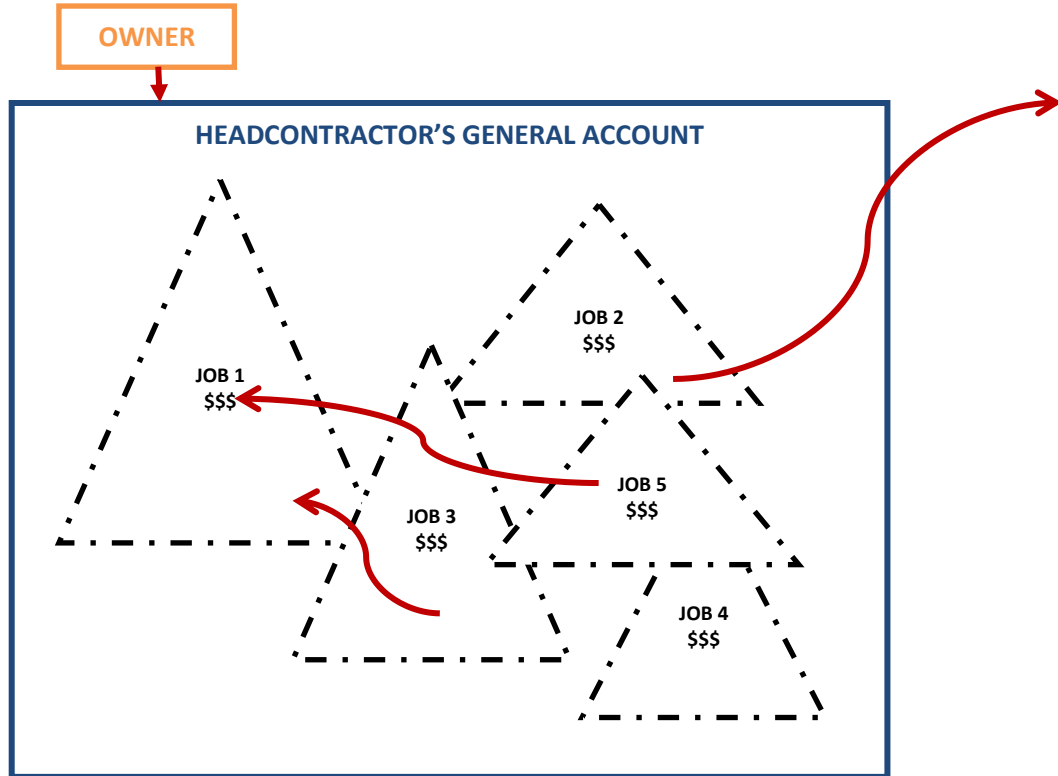
DISTRIBUTION OF MONEYS IN TRUST ACCOUNT UPON INSOLVENCY OF HEAD CONTRACTOR

1. If the Subcontractors' claims are less than the amount in the trust fund then the **Subcontractors' claims are paid in full** and the remaining amount is the property of the Head Contractor (in liquidation), which is available for distribution to the creditors of the Head Contractor.
2. If the Subcontractors' claims are equal to the amount in the trust fund then the **Subcontractors' claims are paid in full** and any remaining amount of interest is the property of the Head Contractor (in liquidation), which is available to creditors of the Head Contractor.
3. If the Subcontractors' claims are greater than the amount in the trust fund, then the **Subcontractors' claims are paid rateably** (as explained in Illustration (E)).
4. To recover the any moneys still owing, Subcontractors can lodge a claim for the balance in the usual course (standing as unsecured creditors).

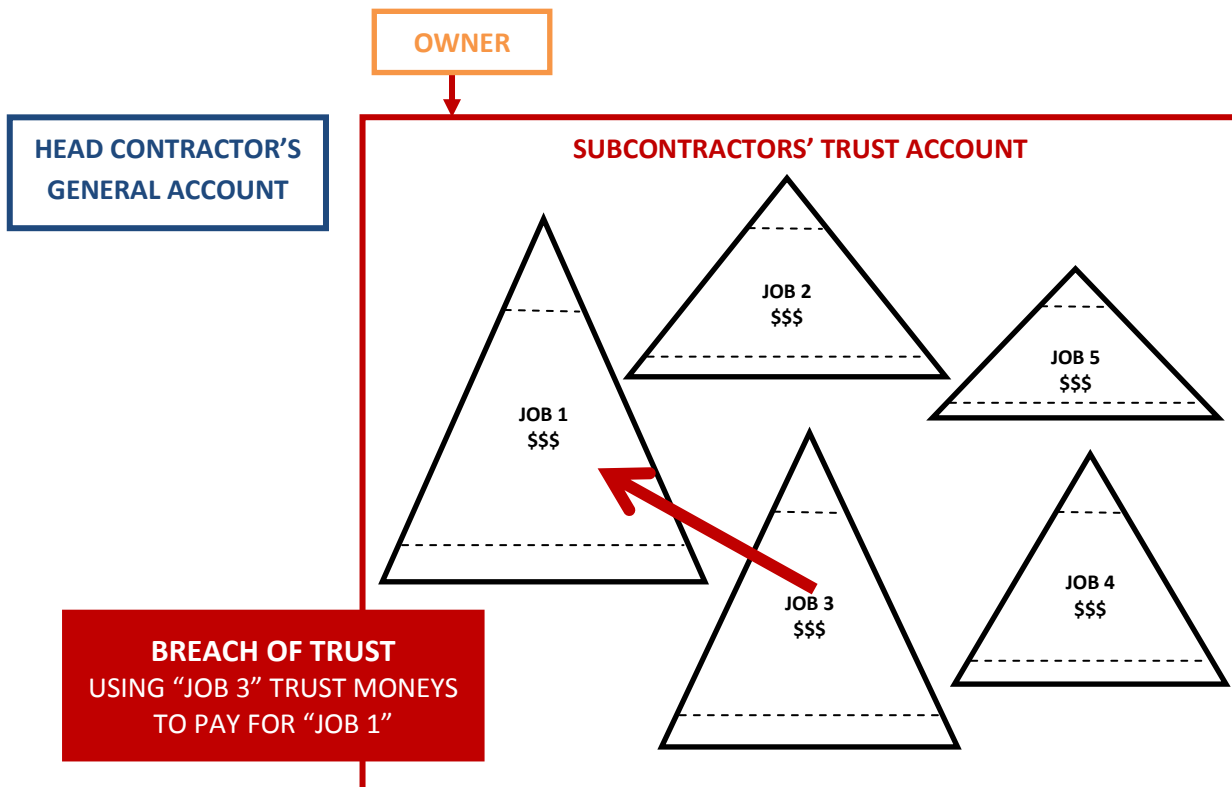
JUGGLING THE CASHFLOW

“Robbing Peter to Pay Paul”

Flow of moneys under the current law:



Flow of moneys under the Statutory Construction Trust Proposal:



Conclusions

Conclusions: the statutory construction trust

Education

There is undoubtedly a need for careful education of the industry to explain the way in which the construction trust operates.

When the Inquiry's recommended statutory construction trust has been trialled and analysed with members of the industry who have been invited to take a critical position and make critical comments about the Inquiry's trust proposal, there has been a rapid uptake in understanding and a rapid uptake in agreement with the way in which the trust operates.

The incontrovertible fact is, that the statutory construction trust is the only way that protection can be afforded to subcontractors against the kinds of problems evidenced in the Reed Constructions Australia (Pty) Ltd case and so many others which gave rise to the establishment of this Inquiry. If the construction trust is to be considered, it must be considered in that light, namely, that the Inquiry cannot answer satisfactorily what would be the most effective remedial mechanisms to assist subcontractors in the event of a head contractor's insolvency, unless it recommends the establishment of the statutory construction trust.

Unintended consequences

Like any reform initiative, there are many matters to be considered including the effects of unintended consequences. When the Inquiry took into consideration the sorts of problems and issues relating to payment practices in the building and construction industry (analysed in this Report), what has emerged in opposition to the construction trust concerns the way in which banks and insurance companies treat the moneys in the head contractors account in respect of subcontractors' claims. There is significant evidence that banks and insurance companies approach that money as if it is a secure fund free of any other claims, legally owned without qualification by the head contractor and thus available whenever it needs to absorb any pre-existing debt of the head contractor.

Nevertheless, the matter must be fairly placed at the centre of any report such as this, so that Government may see where the tipping point might be. Should banks and insurance companies be entitled, having regards to the generous way in which most security documents are drafted, to deftly elbow in and take moneys from the head contractor's account when "everyone" knows that such moneys have only been paid

into those accounts for the purpose of paying subcontractors for the work that the subcontractor performed and any materials supplied?

To the Inquiry there can be only be one answer to that question and if that involves a readjustment of the way in which head contractors and banks and insurance companies carry on their business, then so be it.

During analysis and whiteboard sessions with a number of substantial head contractors there was a discernible shift in the views of those contractors. Some agreed outright with the principle and did not see it as having any burdensome effect on their business.

As the Inquiry reflects upon the cavalcade of witnesses who came to give evidence one group stands out for special reasons. There were a significant number of outstanding young executives who oversee high quality construction companies and are driven by integrity and a desire to excel. The personal qualities of these young men were exceptional and the Inquiry was not surprised to learn that in each case their talents had contributed to the high standing and repute in which their companies were held in the business community. Some of these executives who were initially not well disposed to the construction trust, returned for further meetings with the Inquiry and engaged in close analysis in workshop sessions of the construction trust. Some of these executives altered their view and expressed the opinion that they could “live with the construction trust.”

Great care must be taken however not to make too much of that as a result in itself. The Inquiry was impressed with the open minded approach taken by these executives. From that the Inquiry takes some confidence that when the trust is explained and workshopped with others, a similar acceptance will follow.

It needs to be said however that the acceptance by such executives of the construction trust was less a tribute to efforts to persuade, than it was due to the fact that these companies, as a result of the way they are managed, ensure that they do not have to “rob Peter to pay Paul” and that there is always depth of reserve in their balance sheet to enable them to pay subcontractors no matter what the vicissitudes at any given time.

On this same subject, the Inquiry is also indebted to one highly reputable and successful construction company, for its careful submission. In that submission, the company said:

“While reassured by the discussion we had on trust, we are very concerned that individual accounts per project will add administrative burden and complexity, worse at the smaller end of operations where the work is characterised by many small projects. If the Inquiry seeks to provide solutions across the industry, the trust account must be a general account, not a project account.

Equally, we do not understand why a bank would accept the extra liability that goes with the project account; however, this is not our area of expertise.”

This concern has been addressed in the section of the Report that deals with the establishment of one trust account in the same way that solicitors, real estate agents and travel agents operate their trust accounts. This account will be the trust account for all of the projects and will be run on the usual ledger system.

The Inquiry has concluded upon what it regards as a strong evidentiary basis that a period of introduction, explanation and discussion concerning the statutory trust will continue to have that effect and that up to now, most of the criticism of the trust has been based upon a misapprehension of something with which the concerned parties had had no previous experience.

The views of the Australian Bankers Association

The Inquiry sent to the Australian Bankers Association (the Association) a copy of the Discussion and Issues Paper which had canvassed in considerable detail the issues surrounding the statutory construction trust.

In addition to sending the Discussion and Issues Paper to the Association, the Project Director forwarded emails to the Association requesting their response to the matters raised.

In response to those invitations the Inquiry received a submission from the Association on 13 November 2012 in which it was said in relation to the project bank account arrangement (one that is markedly different to the construction trust which is recommended to be made compulsory):

“...this approach has been discussed with a number of the major banks. We believe it would be legally possible for a bank to operate PBAs, although banks may need to put in place mitigating measures to reduce the risks to the bank from this type of account.

If this approach is to be taken, we recommend that an industry agreed form of trust deed be prepared for use with PBAs, to reduce the cost associated with the operation of the PBAs. Extra and unnecessary costs and delays would be incurred if a non-standardised approach were taken and banks were therefore required to review the terms of the trust deed applicable to each transaction.

We note, however, that while PBAs may have some benefit, we do not believe that PBAs will prevent financial distress in construction, or reduce the disproportionate number of constructors/sub-contractors in the insolvency statistics, which we understand is the Inquiry’s main objective. This is because PBAs only address payment liquidity, which is already addressed in part by various ‘security of payment’ laws in each State.”

In that submission the Association then went on to provide the following helpful statement outlining the:

“.....more fundamental causes of construction distress, including:

- *low margins (profit margins are often less than 5%), in part as a result of the low barriers to entry for non-specialist sub-contract work and to excess supply in most trades (outside of resource projects in regional Western Australia and Queensland);*
- *effective high fixed costs, with contractors incentivised to bid finely to maintain work flow and activity for workforces, either direct or sub-contracted;*
- *peaks and troughs in activity, with the sector having a greater amplitude than the general economy; and*
- *inherent risks in programming and costing, and risks to those elements from weather and price escalation, combined with varying degrees of financial and operational capability across sub-contractors.*

Although the PBAs are likely to do little to avoid financial distress, they could be valuable in dealing with the costs of that distress. By avoiding the comingling of funds, PBAs should reduce the time and cost of any administration, as it will be much simpler to identify the funding and cost arrears of each of a failed builder's projects (although this benefit maybe be diluted or lost if each project or contract does not have a dedicated PBA).”

The Inquiry (noted earlier in the Report) asked the Association:

How banks view the progress payments made to head contractors for work predominantly performed by subcontractors?

“.....a bank is entitled to rely, without inquiry, on the payment instructions of the account holder. Progress payments will be made at the request of the owner/principle (sic) to the head contractor, with the bank having the option of confirming that the necessary work has been completed. The bank will not have line of sight of arrangements for payment made between the head contractor and any subcontractors.”

The Association was also asked by the Inquiry for advice on:

Any issues/problems associated with a builder/contractor using one account (that will be the trust account) that is able to facilitate a number of different transactions with different entities.

“We cannot see an issue with this as presented to us. Any account allows payments to multiple parties from that account and those payments can be tracked. We are aware that some banks enable customers to export account details to Excel or other financial management systems. This could then be used

to generate a reporting system for individual payees. Some banks also offer sub-accounts within main accounts, but this is not offered by all banks.”

The Association went on to say:

“We also note that caution is needed with any proposal that would involve the mixing of trust funds with other funds as this may cause issues from a legal perspective. A trustee has a duty not to mix trust funds with its own funds or the funds of other parties. It would only be in circumstances where the trustee has the specific power to mix trust funds that it could do this. Accordingly, the terms of any trust deed associated with the account would need to be explicitly allow for this, if this is what is being considered.”

Of course the Inquiry’s proposal does not require a trust deed but otherwise the comments of the Australian Bankers Association are both welcomed and not disputed by the Inquiry.

Single trust account: multiple projects

In order to obtain more comfort as to the likely cost and inconvenience of a trust account with multiple ledger entries, the Inquiry also briefed Ms Jean Sayer who for many years has been the professional accountant to whom the Law Society of NSW turned for difficult trust account problems and for the conduct of receiverships involving failed solicitor’s practices.

Ms Sayer also confirmed that it would be quite appropriate for the Inquiry’s trust fund proposal to be operated through a single trust account involving ledger entries for each project. She also confirmed that such an account could also accommodate the details of the necessary retention funds across a number of projects maintained by contractors.

During the work carried out by the Inquiry it had a number of meetings with interested senior practitioners in the construction industry and from time to time workshopped a number of propositions with such people. One of those gentlemen with the help of a chartered accountant with considerable experience in the construction industry came up with a number of points which they jointly presented to the Inquiry.

Having expressed a view unsupported by any evidence that the construction trust would add extreme complexity to doing business and add costs to business in NSW, their initial submission nevertheless went on to say that some principles should be standardised into NSW legislation. One of those principles was that:

“If the Contractor receives payment under the Contract for, or on account of, work done or Materials supplied by the Subcontractor, and does not pay the Subcontractor the whole amount to which the subcontractor is entitled under the Subcontract, the difference is held on trust for payment for the work done on Materials supplied.”

The proposition that this principle should be made part of the law of NSW is of course, a wholesale embrace of the statutory trust.

They also suggested that:

“Licensed builders should be required to keep separately identified provisions in their audited accounts for monies held on behalf of subcontractor and supplier progress payments. Retention and cash securities. These provisions should be formally audited for licenced builders on a 6 monthly basis and should be available for inspection by the relevant authority upon request. Principals should also be required to do the same.”

They also recommended that:

“Moneys held in Builder accounts and identified as provisions in trust to pay for subcontractors progress payments, retention and cash securities by law cannot [be] accessible to the builder’s bank or other financial institution.”

These recommendations were welcome contributions to the work of the Inquiry and were an acceptance of the statutory trust proposal.

The Inquiry was interested to determine whether such propositions could be dealt with in the subcontractor’s general current account in a way which afforded the same protections as the trust account. The Inquiry was advised by Ms Jean Sayer that it was not possible within the confines of a general current account to earmark all of the moneys or accounts with the bank as trust accounts. The Inquiry was in agreement with Ms Sayer’s approach.

Concluding remarks on criticisms of the construction trust

The Inquiry has read and considered all of the criticisms it has been able to unearth relating to the construction trust. Some of those criticisms are criticisms of a model which is not recommended by the Inquiry. These criticisms may be discarded.

Some of the criticisms are answered by the form of the Inquiry’s recommendations themselves.

Some of what have been called criticisms are not really criticisms at all. They are descriptive of valuable attributes of the Inquiry’s recommendation.

Third parties will only become involved when they have wrongfully participated in a breach of trust. It is difficult to see how any commentator could suggest that that is a negative attribute of the construction trust. It has been one of the characteristics of the construction trust which have commended it to many people.

Some of the analyses of the construction trust which have reached an adverse conclusion, in a particular respect, contain themselves a number of other conclusions⁵⁷⁸ favourable to the trust concept.

Some of the conclusions are simply wrong and the error is egregious. Very often in those cases the error is constituted by a mere assertion of a conclusion with no pretence to structure a set of reasons which attempt to lead up to and support that conclusion.

Some of the criticisms are based on a complete misapprehension of the concept that is sought to be criticised.

Many of the so called criticisms are not really criticisms at all. They are the musings of a writer who is not prepared to drill down into a genuine analysis of the construction trust proposal and find out what its attributes and legal characteristics might be. Or, in the event that problems are identified, offer any suggestions or alternatives apart from, "it's all too hard."

When the errors are corrected and the construction trust is analysed in the context of all of the recommendations made by this Inquiry, the reader is left with the old chestnut, the vague and unsupported allegation of administrative difficulties.

The Inquiry has not been provided with any evidence of those difficulties.

The Inquiry's conclusions in relation to the construction trust for reasons indicated earlier, has been the subject of considerable debate caused by the lingering effect of the errors in the Anderson Report.

Cash flow

Much has been said in the Inquiry about "cash flow" as if it were a *cri de coeur* expressing entitlement. Even Lord Denning was enlisted to support the cause. Yet an examination of *Dawnays v. F. G. Minster Ltd*,⁵⁷⁹ the case cited in aid of Lord Denning's support for cash flow, fell short of the mark. The full quote shows that Lord Denning did not in terms use the words "cash flow", however he was referring clearly to the *subcontractors'* cash-flow:

"That seems to me to run counter to the very purpose of interim certificates. Every businessman knows the reason why interim certificates are issued and why they have to be honoured. It is so that the subcontractor can have the money in hand to get on with his work and the further work he has to do. Take this very case. The subcontractor has had to expend his money on steel work and labour. He is out of pocket. He probably has an overdraft at the bank. He cannot go on unless he is paid for what he does as he does it. An interim

⁵⁷⁸ For example the Price Waterhouse Report and the Andersen Report.

⁵⁷⁹ (1971) 1 W.L.R. 1205 at 1209-1210

certificate is to be regarded virtually as cash, like a bill of exchange. It must be honoured. Payment must not be withheld on account of cross-claims, whether good or bad - except so far as the contract specifically provides. Otherwise any main contractor could always get out of payment by making all sorts of unfounded cross-claims. All the more so in a case like the present, when the main contractors have actually received the money."

Numerous witnesses spoke of their need for "cash flow" as entailing a corresponding right to use subcontractor retention and progress payments. In effect "their cash, my flow."

Yet no witness offered any solutions to the problem the Inquiry has been asked to examine, "*how can the cash of the subcontractor be used in that way with a guarantee that loss of payment for the subcontractor's work and materials will not be the result?*"

The answer put forward by the Inquiry is the statutory construction trust.

The Architecture of the Inquiry's Recommendations

A failure to incorporate a requirement that contractors maintain an appropriate financial backing commensurate with the level of the projects they undertake will mean that at the preventative end of the spectrum there will be no safeguards for subcontractors against the insolvency of the head contractor. Subcontractors will remain entirely unprotected at the threshold and will be reliant upon the protection afforded to them by the construction trust,⁵⁸⁰ after the insolvency of the head contractor.

The protection provided by the construction trust only comes into its own after the contractor becomes insolvent. Moreover, that protection will not extend beyond the amount of the progress payment (or in rare cases progress payments) which have been made by the principal, paid away by the head contractor or absorbed into the head contractor's insolvency and not therefore paid on to the subcontractor.

In the view of the Inquiry it is incontestable that remedial measures which centre around the construction trust and do not involve the critical prophylactic requirement that contractors begin their life in the industry upon a sound financial footing with their financial health the subject of regular statutory checks, will only address a part of the problem. Without financial regulation there will continue to be an unacceptably high level of insolvencies. It is as plain to the eye as can be that the maintenance of a healthy industry follows naturally from a series of statutory provisions designed to maintain the individual health of the participants in the industry.

There are other important benefits all of which are germane to the Inquiry's Terms of Reference, to be gained from the introduction of the financial backing requirements. They include the important role such a measure has to play in:

- i) The stability and the organisation of the industry;
- ii) The orderly structure of the industry;
- iii) The confidence with which participants in the industry may approach and deal with other participants in the industry;
- iv) The reduction of risk of non-payment margins in subcontracting tendering. This risk margin has traditionally been one of the only ways subcontractors have considered to be available to protect themselves from insolvencies;
- v) The maintenance of a low barrier to entry, which in the Inquiry's opinion, is a desirable feature of life and work in Australia provided that at the same time, the sliding scale of the financial backing requirement establishes a ladder for prudent advancement within the industry from a relatively low

⁵⁸⁰ The Construction Trust is analysed in detail in an earlier section of this Report

- value project commencement, to the higher value projects which lie in prospect for a hardworking, competent and well organised contractor;
- vi) Their place in an integrated framework. The Queensland model has demonstrated, and the evidence before the Inquiry has confirmed, that company accounts, even those audited by the best professional accounting entities, have a low shelf life and that after about six months or so there is an extremely steep erosion in the capacity of such accounts to provide an accurate picture of the future of the financial welfare of the contractor. In NSW there have been numerous examples of the breakdown of the somewhat flimsy safeguards in that regard. The Queensland model of “the auditor at your door” is one to be envied;
 - vii) The protection and confidence of the public.

Not all of the remedial legislation recommended should be driven through the rear view mirror and so legislation should be introduced which is prophylactic in nature in order to ensure that a financially sound membership may operate to reduce the number of insolvencies in the long run and thereby reduce the adverse effects of such insolvencies upon others, particularly subcontractors.

Building contractors at all levels of the industry should be required to maintain a current asset backing commensurate with the value of the particular project in question. The model for this legislation is to be found in the financial requirements for licensing in the *Queensland Building Services Authority Act 1991* (QBSA). Table 1 of the “Financial Requirements for Licensing” pursuant to the QBSA Act sets out by categories (1-8 inclusive) the requisite allowable annual turnover and net tangible assets required to be demonstrated and maintained by building contractors in each of those categories. The link is then made between builders who are licensed in particular categories and the project value of the work they are permitted to undertake under the QBSA Act.

Short of the establishment of the full Queensland model, and while a full cost benefit analysis is carried out, in order to support that framework the NSW Department of Finance and Services should be empowered to carry out the requisite financial checks which are in section 6 of the QBSA “Financial Requirements for Licensing”, required to be undergone by the building contractor on the basis of up-to-date relevant financial information. Under the QBSA Act which is the model for this recommendation:

“...licensees may be required to provide the authority with financial information, in accordance with this policy, at times other than on application or renewal of a licence. Where such information is required, it must be provided in order to ensure compliance with this policy. Reports prepared and

*signed any earlier than 30 days prior to the date of receipt by the Authority will not be accepted.*⁵⁸¹

This section empowers the QBSA:

*“...to give written notice to a licensee requiring delivery of, or access to, specified financial records in circumstances where the Authority is satisfied, because of information received, that there are reasonable grounds for concern that the licensee does not satisfy the financial requirements stated in this policy.”*⁵⁸²

As the Inquiry proceeded and as more and more people have been engaged in detailed discussions with the Inquiry, one of the dominant themes that continued to be woven through all of the discussions is the unanimous view that the Queensland licensing system with its attendant scale of financial backing graduated according to the value of the project, is the principal provision in any law reform proposal.

The consistent view of those who have had countless years of aggregated experience in the industry, is that the Queensland model is one which works. It allows the contractor “to find its own level” and permits the contractor the opportunity to move up the graduated scale according to its competence, success, inclination and financial backing.

The Queensland model is the only sure-fire way to safeguard the health of the industry in the sense that it provides health checks on the individuals in the industry and then assigns levels of activities to those individuals according to their financial backing and their proven level of competence.

Once this theme began to emerge early in the Inquiry, through written submissions and discussions, it was then made the subject of numerous questions by the Chairman in many of the 130 meetings in which people have given evidence to the Inquiry and with one exception they have commended the Queensland system.⁵⁸³ It is difficult to imagine any individual finding demanding with such emphatic clarity that it should be placed at the forefront of recommendations to Government. An examination of the wide range of background and experience (in different sectors) of all those who supported this proposal almost immediately, suggests that their views should be given great weight. Conscious of the force of these opinions, the Inquiry has recommended that a cost benefit analysis be undertaken to assess the suitability of a Queensland type model in NSW.

⁵⁸¹ Queensland Building Services Board, “Financial Requirements for Licensing policy document, 1 October 2012, p. 33, section 6.

⁵⁸² Ibid, p. 33, section 6.1.

⁵⁸³ The HIA in its submission to the Queensland Building Services Authority was critical of the integrated model administered by the Authority where they are both insurer and regulator.

The Inquiry has not sought to draft recommended amendments to the edge of the possible. That is for two essential reasons. Firstly the Inquiry has concluded that each of the recommendations which involve legislative change, are within the competence of the NSW Government. Secondly, the Inquiry is of the view that if the recommendations are accepted by government, then it is for the parliamentary draftsman having ascertained the essence of and the reasons for the recommendations, to decide how best to express those sentiments in appropriate legislative language.

Recommendations

Recommendation 1: The New South Wales Building and Construction Commission

- A) That the NSW Government conduct a cost benefit analysis to establish whether to proceed with recommendation 1B.
- B) If the cost benefit analysis demonstrates that the overall benefits outweigh the costs, that the NSW Government establish a separate autonomous statutory authority entitled the “NSW Building and Construction Commission” with the sole responsibility for control and regulation of all aspects of the building and construction industry.

Commentary

This recommendation is not driven by any reflexive approach to the setting up of a controlling body as a suggested panacea for all the problems in the industry. The justification for the recommendation is the inescapable conclusion that a Building and Construction Commission is the only way through which appropriate reforms may be instituted, implemented and monitored. The Inquiry’s primary recommendations, that is those upon which the Government may confidently depend for a reduction of insolvencies in the industry, are those which are set out in recommendations two, three, four, five and six below. These recommendations are not capable of being effectively implemented unless they fall within the responsibility of a body such as the NSW Building and Construction Commission. There is no other convenient Government department, agency or authority which could assume the responsibility for these reforms, nor one which has the necessary expertise to do so. Only a fully integrated organisation will do the job properly. Other States and Territories have established similar bodies.⁵⁸⁴

The Inquiry’s recommendation accords with the opinions of industry bodies such as the NSW Building Professionals Board, the Master Builders Association and the Building Regulations Advisory Council.

⁵⁸⁴ NSW is the only state on the eastern seaboard yet to establish an integrated Building Commission or Authority. Western Australia has also established a Building Commission.

Recommendation 2: All building and construction under the one roof

The NSW Building and Construction Commission, as the name suggests, will include under its umbrella all of the administrative oversight, regulatory and operational responsibilities relating to the NSW *Home Building Act 1989*. This will be a separate specialised division within the NSW Building and Construction Commission carrying out its activities in much the same way as it does now.

Commentary

There is a strong case to be made to consolidate the functions that currently exist into the one body. The following agencies, departments, boards and instrumentalities all play some role in the regulation of the sector:

- NSW Fair Trading
- NSW Building Professionals Board
- NSW Planning
- Self Insurance Corporation (NSW Home Warranty Insurance Fund)
- Long Service Corporation
- NSW Public Works
- NSW Government Procurement
- Home Building Advisory Council
- WorkCover
- Building Industry Co-ordination Committee

The view from the position of an independent outsider, but one who knows what goes on inside, is interesting. A landscape view of the administrative structure in NSW by a person interested in collecting together under the one roof all of the departments, divisions, committees, taskforces and so on, reveals a bewildering series of acronyms, investigations, task forces, consultations, reviews and so on. A firm hand is required to draw all of this material together, beat it into shape, realign it, assign priorities, define, formulate and delegate responsibilities, and shape the organisation so that it neatly befits itself as an autonomous authority to regulate the whole of the building and construction industry in a state of nearly eight million people.

It is inefficient and costly and does not produce any commensurate benefits for the NSW Office of Fair Trading's Home Building Services Division, to be administered in a separate department from the rest of the construction industry. The expertise is essentially the same.

The boundaries and dividing lines between the commercial and residential sections of the industry are artificial, mobile and porous. Much of the work is of the same nature

and governed by similar principles although referable to subject matters which differ in degree, and only marginally on subject matter.

SOPA should be brought under the control of the appropriate body which is the NSW Building and Construction Commission.

The Commission should also be solely responsible for education and dispute resolution functions.

Recommendation 3: A licensing system for all

The first key role of the NSW Building and Construction Commission will be to establish a licensing system which requires all builders and construction contractors operating in the commercial building sector to qualify within a particular graduated licence category according to the net financial backing they are able to demonstrate, in respect of proposed projects. The result will be that the work of builders and construction contractors will be restricted to the category of project value for which they have demonstrated financial backing and licenced accreditation.

Commentary

Aside from the Northern Territory, NSW is currently the only jurisdiction in Australia that does not require builders working in the commercial sector to be licensed. NSW stands alone in not requiring general building and construction contractors to be licensed. The value of the licensing system is already recognised in NSW in the residential building sector and the lack of construction contractor licensing is an anomaly that cannot be adequately explained and which carries with it a number of important disadvantages which are against the best interests of the people of NSW.

No witness to the Inquiry⁵⁸⁵ was against the proposition that commercial builders should be licensed.

Licensing in and of itself, can offer little if anything more than gentle reassurance that a builder has paid a yearly or other fee to maintain a current occupational licence. The Inquiry is recommending that licensing should work alongside other reforms such as capital backing and net tangible asset thresholds, as mandatory requirements to work in the industry.

The Inquiry is aware of the work of the Council of Australian Governments (COAG) to develop and implement a national occupational licensing system for specified occupations, including those in the building and construction sector.

⁵⁸⁵ HIA in its 2 November 2012 submission, queried the usefulness of licensing in preventing insolvency.

Recommendation 4: Financial Health Checks

The second key role of the NSW Building and Construction Commission will be the financial monitoring and auditing of the accounts and financial affairs of all builders and contractors in NSW. There will be a formal set of standard financial and accounting requirements. In addition to those requirements, the NSW Building and Construction Commission will have the power, acting upon reasonable information, to conduct spot audits and to require the production of relevant financial information from building contractors and construction contractors who in the reasonable view of the Commission, may be in or may be in impending financial difficulties.

Commentary

This function has been a particularly active concern of the Queensland Building Services Authority (QBSA). The financial checking, monitoring and auditing system implemented by the QBSA under its enabling Act will be the bulwark of the NSW Building and Construction Commission's work for the purpose of reducing the number of insolvencies in the building and construction industry in NSW. The accounting and auditing department of the NSW Building and Construction Commission will be resourced and trained officers who are experts in the forensic accounting sphere and who have a sound understanding of the complexities of the building and construction industry.

In relation to the home building sector, due consideration should be given to the existing home warranty insurance requirements for licensed builders.

Recommendation 5: Discipline, Complaints and Standards

The third key role to be assigned to the NSW Building and Construction Commission is the role of discipline, complaints and standards.

Commentary

Repeated company failures, newspaper articles, television, current affairs segments, magazine articles and the like, have time and again demonstrated that this is an industry which demands a disciplinary oversight in view of its importance as an economic driver and its capacity and potential to cause widespread and long lasting harm in the community if not regulated. These key roles of the NSW Building and Construction Commission are all of a piece. They suggest inevitably that each role should be carried out by a separate body established for that purpose. It is not appropriate to graft these roles and functions upon other departments which lack the expertise to carry them out.

Recommendation 6: The Construction Trust

Any payment by a principal to a head contractor or by a head contractor to a subcontractor on account of, or in respect of, any work done or materials supplied by the head contractor, any subcontractor, sub-subcontractor or supplier whether as a result of a favourable adjudication under SOPA or not, shall be made and treated in the following way:

- any cheque drawn upon a bank account in favour of the head contractor in respect of such work shall be held on trust for the head contractor, subcontractor, sub-subcontractor and supplier; and
- the proceeds of any such cheques when banked will be held upon the same trust for the head contractor, subcontractor, sub-subcontractor and supplier;
- where moneys are paid by electronic transfer they will be deemed to be held in trust by the head contractor the instant they are received by electronic transfer from the principal.

The statutory construction trust requirement should apply to all building projects valued at \$1,000,000 or more.

The statutory construction trust will be established for the purposes of paying the subcontractors and suppliers.

Commentary

This statutory construction trust is based upon the Maryland construction trust legislation.

The first important characteristic of this trust is that the moneys are not at any time deposited into a bank account owned and operated by the head contractor. There is no point at which the funds may be “scooped” by the bank, nor is there any physical payment outside the trust account by a head contractor to a subcontractor which might attract the unfavourable attention of the rules concerning preferences. Commentary and illustrations which form part of the chapter in this Report headed “The Heart of the Matter”, work through different situations which may occur in practice and which might dictate different consequences according to the circumstances themselves. The head contractor holds moneys upon trust for its subcontractors. A quite distinct trust arises upon payment to the subcontractor who then holds on trust for any sub-subcontractor or supplier. In each case, the objective is to pay the trust moneys out as quickly as possible to those who are entitled to them.

Recommendation 7: Project value threshold for the Construction Trust

The construction trust requirements shall not apply to projects of less than \$1 million.

Commentary

This is the Inquiry's response to discussions on this specific threshold question with the HIA and MBA.

Recommendation 8: All subcontractors to be paid what is due and owing before head contractor draws from the fund

The Inquiry recommends that a provision in or to the effect of 8 (2) of the Ontario Act be inserted into SOPA:

The contractor or subcontractor is the trustee of the trust fund created by subsection (1) and the contractor or subcontractor shall not appropriate or convert any part of the fund to the contractor's or subcontractor's own use or to any use inconsistent with the trust until all subcontractors and other persons who supply services or materials to the improvement are paid all amounts related to the improvement owed to them by the contractor or subcontractor.

Commentary

By that means together with the adoption of the Maryland construction trust model, a layered structure is created so that each contractor or subcontractor holds funds down the line on trust for the person with whom they are in contract. Section 8 (2) of the Ontario Act makes it plain, as does section 8 (1), that the trust applies to suppliers as well as to contractors and subcontractors. That is as it should be.

Recommendation 9: Certificate to bank to pay

Before the head contractor/trustee makes any payment out of the trust account to a subcontractor, it shall submit a certificate to the bank which:

- Certifies that the payment is of an amount due and payable to a subcontractor engaged on (*here state the project*); and
- That it is in order (*here state the sum*) that the sum be paid out to the named subcontractor from the trust account.

Commentary

This measure is intended to achieve two objectives. First it gives protection to banks. Second, it provides a safeguard against unauthorised disbursement by the contractor.

Recommendation 10: Trustee may elect to deposit trust funds into an authorised investment

After the principal has made a progress payment into the trust account, the contractor/trustee may elect to deposit the proceeds of the principal's progress payment into an authorised investment pursuant to the provisions of the *Trustee Act 1925* NSW. If the contractor elects to do so, the funds paid to the contractor by the principal by way of progress payment must be paid into a separate segregated and properly named trust account which plainly describes the nature of the trust account and specifies that the account and the proceeds thereof are being held by the contractor upon trust for specific subcontractors in a named project.

Commentary

Under this proposal the funds remain impressed with the trust. They may be invested by the contractor in any of the investments authorised by the *Trustee Act 1925*. This means that head contractors will retain the right to exercise their "treasury" function to some extent. The funds remain impressed with the original trust if the contractor elects to endeavour to earn more favourable interest. Together with the later recommendations which require the owner to pay the head contractor within 15 days and the head contractor to pay subcontractors within 28 days, this opens up a window of time within which the head contractor may invest progress payments until it is obliged to pay the subcontractor.

Recommendation 11: Interest earned

When moneys are paid out of the trust bank account in the manner described in recommendations 6 and 8 hereof and the effect of such payments is to pay subcontractors in full, the head contractor is then entitled to retain any interest earned on the deposited funds from the date they were deposited into the trust account until the date of the payment out to the subcontractors.

Commentary

This provision is designed to encourage the head contractor to pay the subcontractor quickly so the head contractor may then transfer any interest to its general account.

The recommendation also relieves the head contractor from the effects of the rule in *Keech v Sandford* (1726) Sel Cas King 61; 25 ER 223 and *Regal (Hastings) v. Gulliver* (1967) 2 AC 134 which prevent a trustee from profiting from the trust.

Recommendation 12: Third parties with knowledge of breach of trust are liable

To ensure that the provisions are all embracing and to ensure that where trust funds are dissipated wrongfully, subcontractors and suppliers remain protected, a provision similar to section 13(1) of the Ontario Act should be enacted in NSW. Under the heading “Liability for Breach of Trust by Corporation”, section 13(1) provides:

“In addition to the persons who are otherwise liable for breach of trust under this Part,

- a) Every director or officer of a corporation; and
- b) Any person including an employee or agent of the corporation, who has effective control of a corporation or its relevant activities,

who has sensed to, or acquiesces in, conduct that he or she knows or reasonably ought to know amounts to breach of trust by the corporation is liable for the breach of trust.”

Commentary

This recommendation is designed to mirror the general law rule in *Barnes v. Addy* (1874) LR 9, Ch App 244. It provides a further remedy for the subcontractor, one which is of considerable importance in the event of the contractor trustee’s insolvency. The remedy against the contractor alone would probably be of no value in that situation.

Recommendation 13: Subcontractors’ right to information

The subcontractor who is the beneficiary under the construction trust of which the head contractor is the trustee may, in accordance with its rights as a beneficiary and notwithstanding that payment to them may not be due at any particular time, exercise their rights as a beneficiary to call upon the trustee to provide information as to the time, date of payment and details of payment made to the head contractor trustee by the principal

and payments out of the account to any subcontractor including the right to be informed of any reasons for non-payment or retention.

Commentary

This recommendation is designed to overcome some of the uncertainty in the decided cases. A similar recommendation is made in respect of any subcontractor – sub-subcontractor trust.

Recommendation 14: Accounts and records to be maintained by trustee

Accounts and records shall be maintained by the contractor trustee and the subcontractor trustee. Such accounts and records shall record all payments into the trust account by the principal and all payments out of the trust account by the trustee contractor and the purposes of such payments.

Commentary

Such accounts should not need to extend beyond the bank records of the principal's payments in and the head contractor's payments out of the trust fund. The purpose of the payment will be evidenced by the certificate referred to in recommendation 9.

Recommendation 15: Right to inspect the books of account

All subcontractors who have made claims for payment upon a contractor have the right to inspect the accounts of the trust referred to in recommendation 14.

Commentary

It is important that this entitlement be made clear yet remain limited so that unmeritorious applications by subcontractors to be granted access to the general records of the contractor may be prevented, and not in any way encouraged.

Recommendation 16: Appointment of new trustee

Upon the insolvency of the head contractor/trustee, the beneficiaries, any of them, shall be entitled to make application to the Supreme Court of NSW to a Master in Chambers for the appointment of a new trustee and such application may be made notwithstanding that the due date for payment of the subcontractor's payment claims has not yet

occurred. The court may make rules to facilitate the speedy and cheap disposition of such applications including whether such applications may be made ex parte.

Commentary

A trust will not fail for want of a trustee. This provision restates the existing law. As the fundamental assumption or eventuality against which this reform is intended is the insolvency of the head contractor, those in the industry, viewing the overall concept from the non-legal outside viewpoint, are advised by this means of an important element in the reform.

Recommendation 17: No breach if payment made in accordance with adjudication

It shall not constitute a breach of trust if a contractor or subcontractor pays money out of a trust account in accordance with, and on the basis of a SOPA adjudication and it is later determined by a court, arbitrator or by expert determination, that the amount owing to the subcontractor or the sub-subcontractor or supplier, as the case may be, is more or less than the adjudicated sum paid out.

Commentary

This recommendation provides protection to a contractor/trustee who pays moneys out of the trust account in accordance with an interim SOPA determination.

Recommendation 18: Retention sums

Retention sums as between principals and head contractors and head contractors and subcontractors shall be held in the construction trust account referred in to recommendation 6. Those retention sums shall be paid out of such account in accordance with any relevant certificate, agreement between the parties, SOPA determination, or a decision of a court of competent jurisdiction, an arbitrator or expert determination, as the case may be.

Commentary

Prompt adjudicated dispute resolution is the key determinant of entitlement to the retention sum as it is for a number of the other recommendations. SOPA jurisdiction is to be extended to deal with such disputes. The Government should also consider the alternative of a rapid adjudication system along the lines of the Victorian Civil Administrative Tribunal. The Inquiry is aware that the Government is currently considering models for the consolidation of tribunals operating in NSW.

Recommendation 19: Interest on retention sums

- (A) Subject to the resolution of any dispute concerning the entitlement to the return of the retention sum, the head contractor and the subcontractor, as the case may be, shall be entitled to the interest earned on the fund.
- (B) Where the corpus of the fund is insufficient to provide for the cost of any necessary rectification work, then the interest earned shall also be available to provide for such work.

Commentary

Entitlement to interest should follow the merits of and the resolution of competing claims upon the retention sums. If there is no claim against the fund, all of the interest in the fund should go to the head contractor or subcontractor, as the case may be.

Recommendation 20: Certificate needed to pay

No moneys shall be paid by the principal to the head contractor unless and until, the head contractor has provided to the principal a statutory declaration in the form required by recommendation 21.

Commentary

This recommendation is designed to ensure transparency and is another means to ensure that subcontractors are paid.

Recommendation 21: Legal requirement to provide statutory declarations

Contractors should be obliged to swear statutory declarations that subcontractors have been paid what is due and payable to them. An appropriate amendment to SOPA should be made.

Commentary

This recommendation is designed to address the situation in which there is presently no legal obligation to provide a statutory declaration to that effect. The requirement is presently to be found in contract.

Recommendation 22: Power to prosecute for breach of the Oaths Act

As prosecutions for a breach of the *Oaths Act 1900* (NSW) are at present, essentially in the hands of the police, they should be brought under the umbrella of SOPA so that the NSW Department of Finance and Services which administers that Act, may have the power to prosecute those who commit offences against section 25 and 25A of the *Oaths Act*.

Commentary

This will address the issues discussed in the Report relating to the common situation where statutory declarations are ignored, sworn in the knowledge that their contents are false, or the form of the statutory declaration has been brought about by pressure from the contractor.

Recommendation 23: Endeavouring to circumvent Oaths Act is an offence

It should be made an offence to endeavour to circumvent the operation of section 25 and 25A of the *Oaths Act* by “renegotiating” the terms of payment by in effect, extending those terms of payment by oral agreement at the request of the head contractor, so that the statutory declarant may feel more comfortable in swearing to the truth of the statement that all moneys “due and payable” to subcontractors have been paid.

Commentary

Terms of Reference paragraph 3(g) includes a reference to appropriate and effective financial disclosure between contracting parties, including disclosing payment of subcontractors.

One of the themes of the Inquiry’s Report is the better enforcement of existing laws.

Recommendation 24: Statutory requirement which sets a maximum time for principals’ payment to head contractor

The principal must pay progress payment claims to the head contractor within 15 days of the receipt of progress payment claims in proper form.

Such a requirement should be inserted into SOPA.

Commentary

The best and most effective way to produce an efficient flow of cash through the system is to ensure that it begins promptly at the top. There is a 15 day requirement in Queensland.

Recommendation 25: Offence and penalty rates of interest if head contractor not paid on time

In the event that the principal does not pay the head contractor's progress payment claim in full within 15 days of the receipt of the progress payment claim in proper form, the principal shall be guilty of an offence under SOPA and in addition shall pay penalty rates of interest (to be specified) upon the full amount of such claim.

Commentary

The recommendation that it be an offence, just as it is an offence to break the driving speed limit, is intended to send the clearest message to the community of the importance of the funds flowing from the top of the contracting chain. It is not an offence in Queensland. The Inquiry does not suggest that the penalties ought to be at all severe. This is a recommendation that the Government may wish to scale back for policy reasons.

Recommendation 26: Disputed progress payment to head contractor

Where there is a genuine dispute concerning whether the whole or part of a particular progress payment claim is due and payable to the head contractor, it shall not be necessary for the principal to pay the amount in dispute within the 15 day period and that dispute shall be dealt with in accordance of the provisions of SOPA.

Commentary

It is an important requirement to ensure that these recommendations dovetail with SOPA and that there be a rapid dispute resolution system to ensure the free flow of money out of the trust.

Recommendation 27: Prompt payment of amount not in dispute to head contractor

That part of the progress payment claim which is not disputed by the principal shall be paid to the head contractor by the principal within 15 days of receipt of the progress payment claim.

Commentary

Once again, the fundamental importance of the free and rapid flow of cash is emphasised.

Recommendation 28: Adjudicated sum to be paid into construction trust account – dispute between principal and head contractor

In the event that the principal and the head contractor are not able to resolve the dispute and a claim is taken to SOPA, then any amount the SOPA adjudicator determines is due and payable by the principal to the head contractor shall be paid directly into the trust fund referred to in recommendation 6.

Commentary

The theme of consistency with and the utilisation of SOPA is emphasised. Once again, the dangers of a direct payment to the head contractor's general account are avoided.

Recommendation 29: Statutory requirement which sets a maximum time for head contractor's payment to subcontractor

The head contractor must pay progress payment claims to the subcontractor within 28 days of the receipt of progress payment claims in proper form.

Such a requirement should be inserted into SOPA. Recommendation 32 describes the reasons behind the difference in timing of payments from the principal to the head contractor and from the head contractor to the subcontractor.

Commentary

This ensures the rapid flow of moneys due and payable to subcontractors.

Recommendation 30: Offence and penalty rates of interest if subcontractor not paid on time

In the event that the head contractor does not pay the subcontractor's progress payment claim in full within 28 days of the receipt of the progress payment claim in proper form, the head contractor shall commit an offence under SOPA and shall be liable to pay penalty rates of interest (to be specified) upon the full amount of such claim.

Commentary

As with recommendation 23, this recommendation is a plain statement of the importance the Parliament places upon compliance.

Recommendation 31: Disputed progress payment to subcontractor

Where there is a genuine dispute concerning whether the whole or part of a particular progress payment claim is due and payable to the subcontractor, it shall not be necessary for the head contractor to pay the amount in dispute within the 28 day period and that dispute shall be dealt with in accordance of the provisions of SOPA.

Commentary

This mirrors the position of the head contractor/principal disputes as set out in recommendation 26.

Recommendation 32: Prompt payment of amount not in dispute to subcontractor

That part of the progress payment claim which is not disputed by the head contractor shall be paid to the subcontractor by the head contractor within 28 days of receipt of the progress payment claim.

Commentary

After discussions with senior executives in the industry the Inquiry developed the concept of a buffer in the payment cycle. The object of this buffer is to give additional time to the head contractor who, by reason of its position standing in the middle of the contractual relationship, will then be able to benefit from additional time to pay its subcontractors thus improving its own "cash flow" position. It would work this way – as in Queensland, the principal will be required by statute to pay the head contractor within 15 days of receiving a progress payment claim in proper form. However under

the recommended proposal the Inquiry has formulated, the contractor would be required to pay the subcontractor within 28 days.

This is not to seek to introduce the “pay when paid” proposition by the back door. The justification for this recommendation is the lag created by the fact that the clock begins to run at the bottom of the tiered structure when the progress payment claim from the subcontractor is delivered to the head contractor. This means that the head contractor will be required to pay the subcontractor’s progress payment claim within 28 days of receiving that payment claim yet the head contractor will not be in a position to pass on those claims up the chain to the owner until it has received them from the subcontractor.

So, in the result let it be assumed that the subcontractor’s progress payment claim is received on 30 October 2012 and in line with the recommendations the Inquiry is minded to make, that claim has to be paid by 28 November 2012. The head contractor receives the claim, reviews it, certifies that it is in order to pay the claim or part of the claim and sets out grounds of dispute if any, and then in effect, includes the amount claimed in the head contractor’s own progress payment claim to the principal. The principal will of course require some time to review the claim and to determine what its position will be in relation to the head contractor. That would take the clock through to about 6 November 2012 and then from that time the principal has 15 days to pay in accordance with the Inquiry’s recommendations. In that example the owner would be paying the head contractor say on 20 November 2012. The head contractor will be required to pay the subcontractor in this example by 28 November 2012. The Inquiry is by no means implying that the head contractor is entitled to wait until it receives payment from the principal before it pays the subcontractor. To the contrary. Nevertheless, the timing differences between the two independent⁵⁸⁶ obligations, is intended to assist the head contractor in its management of the process.

The buffer proposal is designed to deal with what the Inquiry has concluded is a wide spread practice of “robbing Peter to pay Paul”. This juggling act commences when a head contractor finds that it does not have sufficient money from within the particular project pyramid⁵⁸⁷ in order to pay the subcontractors who have already done the work and submitted their progress payment claim to it. In that event what is commonplace in the industry is for the head contractor to look to other jobs by way of going to what some contractors call their “treasury”⁵⁸⁸ for the purposes of writing a cheque. This could have the effect of disadvantaging any of the subcontractors in other project pyramids.

⁵⁸⁶ Rather than interdependent.

⁵⁸⁷ See the way in which the expression pyramid has been used earlier in the Report

⁵⁸⁸ Which is nothing more or less than an amalgam of all the moneys passing through the main operating account from time to time.

That might come about for a variety of reasons the most common of which would be the failure of the principal to pay or the failure of the principal to pay on time. In those circumstances what the head contractor must continue to bear in mind is that whether or not the owner pays on time so it remains obliged to pay the subcontractor regardless.

The added advantage of the separation or buffer is that where one job is running at a loss, the head contractor is given more time to get in the share of other progress payments to which it is entitled and fund progress payments to subcontractors in that way.

To this analysis must then be introduced the requirement that the head contractor is required to submit to the principal in its progress payment claim an accompanying statutory declaration in which the head contractor deposes to the fact of payment of the subcontractors of their previous progress claims.

The interconnection of this requirement with the above example is what now must be considered.

Recommendation 33: Adjudicated sum to be paid into construction trust account - dispute between head contractor and subcontractor

If the SOPA adjudicator decides that there is money due and payable by the head contractor to the subcontractor, then such amount shall be paid by the head contractor directly into the trust account referred to in recommendation 6.

Commentary

A mirror of the position one step up the ladder.

Recommendation 34: Contract term void if payment to head contractor longer than 15 days

That any contractual or non-contractual stipulation in or to the effect that moneys properly due and payable by the principal to a head contractor should be paid later than 15 days from the receipt by the principal of a progress payment claim in proper form, shall be void and of no effect.

Failure to comply with the provisions relating to prompt payment will result in penalty rates of interests being paid by the principal.

Commentary

This is intended to assist in the education and reordering of industry attitudes and reinforces the overall reform structure.

Recommendation 35: Contract term void if payment to subcontractor term longer than 28 days

That any contractual or non-contractual stipulation in or to the effect that moneys properly due and payable by a head contractor to a subcontractor should be paid later than 28 days from the receipt by the contractor of a progress payment claim in proper form, shall be void and of no effect.

Failure to comply with the provisions relating to prompt payment will result in penalty rates of interests being paid by the head contractor.

Commentary

This is a complementary position – see recommendation 34.

Recommendation 36: Subcontractor option to suspend work

A statutory provision should be enacted which ensures that in the event of non-payment within 28 days, a subcontractor shall be entitled to suspend the work until it has been paid and that such a suspension will be deemed not to be a breach of contract and any provision which purports to deem or define a subcontractor suspension of work in those circumstances as a breach of contract, shall be void and of no effect.

Commentary

This recommendation addresses the substantially unequal bargaining power between head contractors and subcontractors which often results in a shouldering of risk which has not been priced and which in the case of the subcontractor is inappropriate and inequitable for it to assume. Subcontractors carry out the lion's share of the work.

The subcontractor and its employees' are least able to withstand the pressure and the effect of delayed payment. The subcontractor's business is generally the most labour intensive in comparison with the head contractor and subcontractors are often expected to pay their employees' wages weekly or at least fortnightly.

Prompt payment provisions have been enacted in other jurisdictions and uniformity upon such a basic matter is desirable. Prompt payment from the top down will be an

important impetus for the free flow of funds in an industry of considerable importance within the overall economy of NSW and Australia.

Recommendation 37: Dispute Resolution Boards

That in every Government contract with a project value of ten million dollars or more there would be some kind of dispute prevention and dispute resolution process following the lines of those recommended by Dispute Resolution Boards Australia.

Commentary

Dispute Resolution Boards have proven to be effective. They are strongly favoured by Infrastructure NSW.

Recommendation 38: SOPA payment claims

The requirement that contractors' and subcontractors' progress payment claims include the words required under Section 13(2)(c) of SOPA, should be abolished.

Commentary

The Inquiry heard evidence of threats made to prospective subcontractors that if they intended to include those words on their payment claims that they would not be awarded the subcontract.

Recommendation 39: Expand SOPA jurisdiction

The jurisdiction and powers given to adjudicators under SOPA should be augmented by:

- Enabling the adjudicator to decide on an interim basis disputes concerning bank guarantees and whether or not a party was entitled to cash a bank guarantee.
- Providing for the resolution of disputes concerning the entitlement or otherwise to retain retention sums.
- Expanding the jurisdiction to enable adjudicators to resolve disputes in the home building sector in respect of projects valued at \$1,000,000 or more.
- Giving adjudicators power to issue a final certificate after hearing both sides to a dispute involving sums less than \$40,000.
- Time limits be increased yet remaining consistent with speedy resolution.
- Removing the right of a claimant to choose its own adjudicator.

Commentary

Many experienced witnesses expressed considerable dissatisfaction with SOPA and the standard of competence of some adjudicators.

The right to choose a party's own adjudicator brought repeated and justifiably heavy criticism. The Inquiry was troubled to learn that this criticism substantially impaired the overall evaluation of SOPA within the industry.

The expansion of the scope of the Act is to go hand in glove with the SOPA adjudication education recommendation that follows.

Recommendation 40: Training of adjudicators

1. In the light of the additional functions which have been recommended to be carried out by adjudicators under the provisions of SOPA, there should be instituted a more intensive and detailed training course to be successfully completed before any person can qualify to act as an adjudicator and exercise functions under SOPA.
2. Adjudicators' training and refresher courses should be devised and conducted by an independent neutral and competent body qualified to do so, such as the Institute of Arbitrators and Mediators Australia. Payment for such courses shall be made by the applicants and the Institute of Arbitrators and Mediators Australia shall be entitled to levy reasonable charges for the development and conduct of such courses.
3. Such courses of instruction and training should be open only to those who have had substantial relevant experience in the building and construction industry and shall consist at least of the following modules:
 - Analysis of the *Building and Construction Industry Security of Payment Act 1999* (NSW);
 - Overview of the law of contract;
 - Analysis of building contracts;
 - Analysis of costs and claims in the building and construction industry;
 - Detailed analysis of building construction claims and contractor entitlements; and
 - An overview of the law of building and construction.

Commentary

Further course content will be devised by the same education committee referred to in recommendation 43.

Recommendation 41: Concerning Government

Require Government to re-evaluate its order of priorities in the tender situation. Government should not be contributing to the production and submission of tenders which can drive building contractors down to unacceptably low margins.

Project Bank Accounts should be utilised on every Government project.

Financial checks should be carried out on a rolling basis.

Commentary

Both Reed Constructions Australia Pty Ltd and St Hilliers Construction should not have got through the financial assessment net. In one sense it does not really matter exactly how the assessment process fell short. In those two cases, a proper financial evaluation should have led to the conclusion that the companies were not then suitable for government contracts for the work associated with those tenders. It cannot be beyond the wit of careful financial analysis to devise an effective system of financial evaluation which takes into consideration all of the known peculiarities and proclivities of those whose world consists of the preparation of financial reporting material. It looks as if the financial assessment reports made by the companies engaged by the Government may just have been adequate and in the Inquiry's view the errors by Government may well have been as follows:

- The Government did not request the top level, top of the line financial check.
- The Government did not subject the financial assessment reports to further analysis in spite of there being indicators in the report suggesting that further analysis was required.

Recommendation 42: Mischief and unintended consequences

In order to guard against any attempt to tie up funds in the trust and prevent the free flow of cash to intended recipients the Government should legislate to ensure that when a subcontractor or sub-subcontractor as the case may be, disputes the amount owing to it, that the subcontractor or sub subcontractor shall in the first instance be required to make its claim through SOPA.

Commentary

While it is unlikely, it is possible that a subcontractor or sub subcontractor for tactical reasons may elect not to avail itself immediately of SOPA and it may instead take its case directly to arbitration or to court as the case may be. The SOPA legislation permits a claimant to do that. See s. 32 of SOPA.

It is conceivable that a subcontractor may wish to expose itself to the lengthy delays that choice would entail, particularly when compared to SOPA, because of a perceived bargaining advantage it might gain by seeking injunctive relief to tie up moneys in the fund.

The draftsmen of any amendment could no doubt take appropriate steps to avoid this result.

There are a number of answers to the problem. Firstly, subcontractors with prior claims would have to be paid first, in order that the contractor may comply with the 28 day obligatory payment period. Yet that does not completely deal with the problem.

The Parliament can also provide for a rapid final determination of that particular subcontractor's claim either by augmenting SOPA's powers to enable it to make a final determination or establishing a specialist tribunal to do so. Either way the disadvantages of a short wait for either result are far outweighed by the advantages.

Recommendation 43: Education

The industry as a whole has the capacity to draw upon a wide range of education material. However the industry needs to take the whole of that material, work with experts in the education field and produce targeted syllabuses for particular purposes. This recommendation does not stop at those subjects which will improve financial education and administrative skills. The time has passed for off-hand comments to be made about the lack of education in the industry.

An education committee consisting of representatives from the Office of the Small Business Commissioner, the Housing Industry Association, the Master Builders Association, the Institute of Arbitrators and Mediators Australia and representatives from the Department of Education and Communities should be brought together to develop programs which cover the full range of skills and subjects in the building and construction industry aside from those specialist trade and certificate courses the purpose of which is to provide certification.

Commentary

The Report provides the detail.

Recommendation 44: Transition

That any legislative reforms enacted in accordance with the recommendations of this Report should:

- Be the subject of an advisory and education program;
- Be set out in the form of an Exposure Draft; and
- Be transitioned into law over a two year period.

Commentary

Each of the elements in this recommendation follows from numerous observations in the Report.

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HIA NSW & ACT 2012 Training Directory

Master Builders Association

MBA training program

The building business start-up kit

The Institute of Arbitrators & Mediators Australia

The Practitioner's Certificate in Mediation

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- (Re)construction August 2012

Korda Mentha Seminar (Presented by David Winterbottom)

- Insolvency Construction presentation 29 August 2012

Australian Procurement and Construction Council

Developing the Government Procurement Profession

Building Government Procurement Capabilities

CFMEU

**CFMEU Training School (Occupational Health and Safety Courses
and First Aid, Vocational and WorkCover NSW training)**

Master Plumbers Association of NSW

The Plumbers Online eLearning Portal

Queensland

Queensland Building Services Authority

Better Building Shows – Contractor Education Program 2012

The Building Game, Successful Business Strategies Workshop Workbook

The Building Game, How to Survive in Challenging Times brochure

Better Building Shows “Build a Better Business” folder

BSA ‘Useful Contacts’ list (Approved Managerial Courses)

BSA “Want to get Paid Quicker?” Information Kit

BSA Presentations for:

- Project Management and Supervision
- Contractual Obligations
- Business Planning

BSA DVDs for:

- BSA Contractor Education SuperShow
- BSA Better Building Shows ‘2010 Better Building SuperShow – Your Tools’
- BSA Building & Construction Industry SuperShow 08

Housing Industry Association

HIA Queensland July-December 2012 Training Directory

Master Builders Association

MBA accredited courses list

Victoria

Holmesglen

Holmesglen Community & Industry Short Courses – Certificate IV Building and Construction (Building) Fast Tracked

Building Commission Victoria

‘Security of Payment in Victoria – the fast and easy way to get paid’ presentation slides

CPD – Continuing Professional Development guide

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- “Relax with confidence – By increasing your cash flow and profitability through enhanced credit management procedures” (brochure)
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- About ACIF
- ACIF Forecast briefing overview (Powerpoint slides)
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Canada	<p>Joint Government/Industry Task Force, <i>Builders' Liens – Towards Greater Assurance of Payment</i>, 1 December 1989, Alberta Canada (1989 Alberta Taskforce Report)⁵⁹⁰ [referred to in the 1991 Qld Discussion Paper].</p> <p>Newfoundland Law Reform Commission, <i>Report on the Mechanics' Lien Act: Certain Substantive Issues</i>, 1990, Commission, St John's. (1990 Newfoundland Report)</p>
UK	<p>Latham, Sir M., <i>Constructing the Team - Final Report of the Government/Industry Review of Procurement and Contractual Arrangements in the UK Construction Industry</i>, 1994, HMSO, London. (1994 Latham Report)</p> <p>Construction Task Force (Great Britain) and Great Britain Department of the Environment, Transport and the Regions, <i>Rethinking construction: the report of the Construction Task Force to the Deputy Prime Minister, John Prescott, on the scope for improving the quality and efficiency of UK construction</i>; foreword by Sir John Egan, 1998, Department of the Environment, Transport and the Regions, London. (1998 Egan Report)</p>

⁵⁹⁰ Despite best endeavours, the Inquiry was unable to obtain a copy of this Report.

Appendices

Industry Reference Group

Organisation
Civil Contractors Federation (NSW)
Master Builders Association (NSW)
Housing Industry Association
Law Council of Australia
Construction Forestry Mining and Energy Union - NSW
Insurance Council of Australia
NSW Small Business Commissioner
NSW Chamber of Business
Unions NSW
Insolvency Practitioners of Association of Australia

Terms of Reference

The construction industry in NSW has a high rate of insolvency. The industry accounts for fifteen percent of businesses in NSW, but up to thirty percent of the companies going into administration. The government is concerned about this high rate of insolvency and the impact it is having on the community, small businesses, the NSW economy and the government's construction program.

The government is establishing an independent inquiry to:

1. Assess the extent and cause of insolvency in the construction industry.
2. Consider payment practices affecting sub-contractors, existing protections for subcontractors and the impacts of insolvency on sub-contractors.
3. Consider legislative or other policy responses that can be taken to minimise the incidence and impact of insolvency in the industry, including:
 - a. options for improving the priority given to unsecured creditors where the debt results from a sub-contracting relationship
 - b. opportunities to simplify debt collection processes
 - c. strategies to improve financial management skills in the industry
 - d. a mandatory insurance scheme to secure payments to sub-contractors
 - e. a discretionary mutual fund to compensate contractors from losses arising from insolvency of a lead contractor or principal
 - f. the effectiveness of trust arrangements in protecting sub-contractor payments retained by a lead contractor or principal
 - g. mechanisms to ensure appropriate and effective financial disclosure between contracting parties, including disclosing payment of sub-contractors
 - h. other relevant issues or innovations raised by the Small Business Commissioner or stakeholders.
4. In developing recommendations the inquiry should consider the impact of Commonwealth jurisdiction over insolvency.
5. The inquiry will receive advice from an industry reference group including industry key associations and the Small Business Commissioner.

The government has established a taskforce to review government procurement and contract administration processes. The inquiry will also consider the work of this taskforce.

Given the role of the Australian Securities and Investment Commission, it is not the role of the inquiry to make findings in relation to particular incidences of company failure. However, examples of failure may inform consideration of policy and legislative options.

The inquiry will seek submissions from the construction industry, financial professionals, relevant government regulators and the public.

The inquiry will report within three months of being established.

Case Study 1

'Company A'

'Company A' is a licensed electrical contracting company based in Fyshwick in the Australian Capital Territory servicing the city and surrounding regions.

The business employs 10 workers and is typically engaged on jobs up to a maximum of \$1.5 million.

The company contacted the Inquiry after the National Electrical Contractors Association (NECA) had advised members that the Inquiry was interested to hear from subcontractors affected by insolvency in the construction industry.

In 2011, the company was engaged by Reed Constructions Australia Pty Ltd (Reed Constructions) to perform electrical contracting work on an ACT Government schools project. At the time of engagement, the company could not commit to a bank guarantee, so a cash retention agreement was made with Reed Constructions. The value of the retention money held by Reed Constructions was \$41,000.

At the time of gaining the contract, it was a relatively young company with 5-6 tradespeople employed, together with an office administrator. The Reed Constructions contract was worth \$1.5 million - a very significant job for the company.

Work was completed on the project in 2011 with the defects liability period ending July 2012. There were no outstanding issues relating to the work performed by the company under contract to.

Administrators Ferrier Hodgson announced on 15 June 2012 that Reed Constructions had been placed in voluntary administration. At this time the retention money had not been paid.

The company worked with the administrators and provided written documentation relating to the work performed, however were not optimistic of receiving payment. It paid all suppliers and subcontractors that it had engaged to perform work on the project. Its contracts with subcontractors did not include a requirement that a percentage of contract payments be withheld as retention money.

The company described Reed Constructions as a top heavy organisation in terms of its management of projects and while progress payments were often late to be paid, the company was not overly concerned about the risk of losing money including held as retention funds. All progress payments were made with moneys outstanding relating to the retention fund.

The company described a number of disputes relating to contract variations including one instance involving an amount of \$50,000 which Reed Constructions eventually agreed to pay. However on payment, Reed Constructions paid only \$45,000 advising the company that they (Reed) had neglected to include an administrative fee of \$5000.

The company advised Reed Constructions that they would seek legal advice from NECA as there was no written/contractual arrangement for this fee. The response from Reed was that if any legal action was initiated on this matter, all payments for work would cease. The company did not pursue the \$5,000 owed to it.

Case Study 2

'Company B' a Prefabrication Business – Western Sydney

Company B has operated in Western Sydney for 15 years, specialising in the manufacture and installation of road and rail infrastructure components.

In its submission the company highlighted two instances where builders had gone into liquidation during the previous 12 months resulting in losses for their business. Despite going into liquidation, the owners of these companies continue to trade under different business names, providing false statutory declarations to head contractors and government departments regarding payment of suppliers and contractors.

The company raises two principal issues relating to Government construction contracts. Firstly, the issue of claims made in statutory declarations that subcontractors and suppliers have been paid not being verified, and secondly that the capacity and competency of successful tenderers for Government business is not sufficiently considered and verified.

In its submission to the Inquiry, the company also highlighted the following practices that were of great concern to them:

- a. Contractors/subcontractors being awarded work in areas where they demonstrably lack the relevant experience and/or expertise. This lack of experience/expertise often results in pricing for that job that is considerably lower than what it should realistically be. In some instances the principal or the head contractor may simply award the work to the lowest bid on that basis alone. However it is this company's experience that principals know the price range within which the work can reasonably, competently and safely be performed and will often select a low or the lowest bid, in the expectation that the contractor/subcontractor will not be able to perform the work for that price. The contractor/subcontractor may only realise this well into the contract period after work has commenced and progressed. At this point, the contractor/subcontractor cannot afford to let go of the work and the principal will not agree to any variation to the contract. In some instances, the contractor/subcontractor will complete the work and incur considerable losses in doing so while in other instances they will simply be unable to pay their bills when they are due, and become insolvent. In the company's experience, this often results in the principal having that work effectively (or at least part of the project work) performed for free or a fraction of what its commercial worth.

In one example highlighted by the company, it supplied a contractor working for a Government instrumentality, and is owed \$32,000 after that contractor became insolvent. In this example, the contractor that won the tender did not have the experience or specific expertise required for the project. In another case, the company supplied an electrical contractor who in its contract with the principal had underquoted on all aspects of the job. The principal would have been well aware that the electrical work had been significantly underquoted after having priced this work in developing the original tender. Despite this knowledge or in this company's view, because of their understanding of the true cost of the work, the principal awarded the contract to the lowest bid. The successful contractor subsequently became insolvent. In a further example provided, the company unsuccessfully bid for a \$160,000 job that again went to the lowest bidder, a company that subsequently became insolvent during the project.

- b. The second practice identified by the company relates to the payment terms of principals which are part of the non-negotiable elements of contracts with contractors and subcontractors. The company representative stated that there was a tier one contractor/builder that was particularly ruthless, structuring their principal contracts in such a way that resulted in inevitable delayed payments to contractors during the project period.

A practice common to this company was awarding contracts to lowest bidders and writing in 90 day payment terms into the contract in the expectation that the contractor would collapse. In many situations this resulted in the principal receiving supplies at no or little cost to it. This arose due to the fact that the contractor had entered into an arrangement with a supplier(s) to provide materials needed for the job. These materials are delivered to the construction site. Upon the contractor becoming insolvent, the materials were in the possession of the principal who under the 90 day payment terms with that contractor had not made a progress payment that would have included sums for the relevant materials.

The supplier under their terms with the contractor had not yet been paid for the material supplied and delivered to the site. The supplier is left to pursue the recently insolvent contractor together with any number of unsecured creditors and has no contractual relationship with the principal through which they may pursue payment for the materials supplied for the project.

Case Study 3

'Company C' a Landscaping Company in Wollongong

Company C was established in Wollongong in 1980. The family owned company works on all types of landscape construction across a wide area including the ACT, Southern Highlands, Sydney and the Central Coast. The company currently employs 15 workers.

The current owner purchased the company after completing his apprenticeship and working for a number of years as a professional landscaper for the company. In its submission, the company state that since 2009, seven companies that they have been contracted to provide services, have gone into liquidation. The cumulative effect of these losses has seen the company declare a loss of over \$300,000 for the financial year 2011/12. They name St Hilliers and Perle Constructions among the contractors that have become insolvent owing their business money.

Through the good will of their suppliers and using the equity they have in their home as security, the owners have been able to continue to trade. However, given the magnitude of the losses and pressure from the Australian Tax Office, they are unsure how long they can sustain the business and their employees.

The owner's make a case that subcontractors need better protection and suggest the following:

- The developer or owner has to have the funding for the project approved and money should be set aside in a trust;
- A percentage amount for variations should be part of the trust arrangement;
- As the builder makes claims, the owner or developer verifies that the work has been done and that payments to subcontractors and suppliers have been made before the next payment is made.

The owner's also suggest that the Security of Payments Act needs to be simpler and cheaper for subcontractors to use. They provide an example of a builder owing them \$60,000 and outlaying \$3,500 to prepare a claim only to see the builder become insolvent.

The submission also highlights the issue of retention money withheld by contractors, confirming the widely stated industry practice of 10 per cent of each claim withheld until 5 per cent of the value of the contract is reached. Rather than withholding money from subcontractors, they suggest that onsite monitoring of work performed would provide the proof that the work was done and of a satisfactory standard.

As is the case for many small to medium subcontractors, the owners do not always have the time nor the financial capacity to conduct due diligence on the contractors they are engaged by. To mitigate this risk, the owners ensure that they are not reliant on a limited number of sources of work and work hard to identify potential contracts across a wide geographical area.

The owner's contend that the 'tier 1' builders know that a lot of work is underpriced, yet willingly sign up the lowest bidder.

Case Study 4

'Company D'

This company contacted the Inquiry after the National Electrical Contractors Association (NECA) advised members that the Inquiry was interested to hear from subcontractors affected by insolvency in the construction industry.

The company has operated out of Wagga Wagga, NSW for almost 20 years. The company offer a range of services including electrical work in commercial, manufacturing and other environments and communications.

They have been involved with two companies that have become insolvent and made the following statement:

"We worked for Kell and Rigby with the Governments BER work here in the Riverina. It was commercial work we don't normally undertake but due to the lack of work in the Industrial areas we focus on, we had to do something. The guarantee of payment was well advertised from the Government for this work as it was to be a stimulus injection for the Australian economy. Contracts were signed and we started the work which was at times high pressure with almost impossible deadlines as the schools needed to be ready by January 2012 for occupancy. We had 6 projects running at once, progress invoicing was used under "the security of payments act" during the works. A lot of extra work was done at no extra cost and weekend work was also required to complete these projects which also wasn't allowed for. Prior to November 2011 K & R stopped paying us outstanding amounts for various projects that were completed in February 2011. We never tried claiming interest on these accounts. We had them on an agreed monthly payment schedule of \$15,000.00 per month until the outstanding balance was payed. This lasted for 2 months until they went into insolvency in February 2012 still owing us approximately \$180,000.00.

We nearly closed up our business over this as we couldn't see how we would possibly recover. Kell & Rigby had produced signed Statutory Declarations stating that all of their subcontractors had been paid, which means they have acted illegally. The principal were also of no help to us receiving

payment which was also obviously very disappointing. I've sent emails to the media regarding this and have exhausted every option legally to get this money. Our legal costs were approximately \$6,000.00 but this doesn't include our lost time chasing the money.

We were then engaged by another company for the electrical installation of two schools Ungarie and Darlington Point. Two remote country towns away from Wagga Wagga. Same scenario as K & R they stopped paying us and gave us the run around for the amount of approximately \$56,000.00 Prior to them becoming insolvent we had taken legal action against them and had obtained a garnishee court order for payment to be made when retention money from the principal was paid to them. Again they had also provided the principal with signed Statutory Declarations stating we had been paid. We never supplied the principal with electrical clearance certificates for these 2 schools and they have been occupied illegally since February 2011. We were advised from our legal team to pass the Garnishee court order to the principal for payment and they were prepared to fight this which would of been a huge cost to us so were scared off by them.

We have been advised by accountancy firms that we now should engage the Hells Angels debt collecting service to recoup some of our costs. So far they have a 100% collect rate around Australia so we may be convinced to go this way. Only problem is that I have a conscience and have to live with what they might do. Something needs to be done at a Government level to prevent this happening again as next time this happens to good honest business people the repercussions could be very ugly for Australia.”

Case Study 5

'Company E' an Electrical Company based in Queensland

Company E is a company based in Queensland however has worked across several states.

The company was contracted by Reed Constructions Australia Pty Ltd (Reed Constructions) on work on an airport in Western Australia in 2011. This was a federal Government project.

The company accepted the job based on previous work done for Reed Constructions in Taree, NSW. The owner has always been very particular about who they worked for and what projects they bid for. The company considered that the Western Australia job as it was a federal Government project, that in terms of payments, it was/had to be, a safe job.

As disputes developed with Reed Constructions, 'Company E' engaged a WA based adjudicator to prepare a claim against Reed Constructions for \$1 million owned under contract and paid a total of \$24,000 to the adjudicator to prepare the claim. The adjudicator found in favour of 'Company E', however the owner states that Reed refused to pay and said “see you in the Supreme Court”.

The owner of 'Company E' wrote to the principal, however they stated that it was not their problem and that he should go to Reed Constructions for any payments due. The owner followed all government procedures, all contractual obligations.

Court action was undertaken in 2011 with a decision approximately 6 months ago – however Reed Constructions subsequently went into liquidation.

As bills mounted and no contract payments, Company E came close to insolvency several times until eventually they simply could not pay their debts. The owner was careful about his responsibilities as a company director and not trading insolvent.

The owner sold the family home to avoid the bank foreclosing and has no assets. The owner paid out his 10 employees.

With no assets the owner and his wife have moved in with their daughter and young grand-children on the Gold Coast.

As the owner is close to retirement age he advised that it is very difficult to find work now – 30 rejections to date. He is considered a suicide risk. “Too old and too tired to start again”.

“I am a member of the AiM, an experienced electrical consultant, electrical contractor and have worked in the industry since 1965. I did everything by the book and was always careful who I worked for. If this can happen to me, what about those just starting out?”

He says that it is “*absolutely fantastic*” that a government is doing something about this – it shouldn’t happen to other people.

Case Study 6

‘Company F’

The sole director of ‘Company F’ was contracted In 2009/10 to build a 'wellness centre' in Bong Bong Rd Mittagong. In 2010, the director received a call from a representative of the client and advised that the job would not proceed due to funding issues. Some six hours later the client called to confirm that the work should proceed with funding secured and all payments for work assured. Contracts were finalised and signed, and included a 30 day payment schedule. Despite the initial uncertainty as to the work proceeding, the director was confident of receiving payment as no problems had arisen on previous work for this client.

Site preparation work worth \$250,000 was performed. However prior to construction work commencing the financier withdrew funding, culminating in the client's company being wound up in 2011. The client's property portfolio was heavily leveraged through loans and there were no funds available to pay moneys owing to the company.

Despite the winding up of the company and the sale of property, there appeared to be little effect on the lifestyle of those connected to the company. The director was owed a total of \$300,000.

In 2010/11, the company was contracted by Kell and Rigby over an 18 month period and subsequently invited to tender for further work on a thoroughbred stud in Moss Vale. After missing out on the work that tendered for, the company was asked to do remedial work on stage one works partially completed by the company originally selected to do the work. The company were then asked to work on stage 2 of the development. The work performed in December 2011 was paid in full. The company continued to work into January and February 2012. In January Kell and Rigby refused to pay the progress claim made for work performed. The director claims that it is very hard to believe that Kell and Rigby did not know that there would be no further payments, however they wanted work to continue. The company received no payment for work performed in January and February 2011 and were owed \$370,000. The director took pre-emptive action, taking issues directly

to the project manager who advised that there was nothing to worry about, payments would be made. The director took him at his word.

The director recounted how he was told by the administrators of Kell and Rigby that the company had been trading insolvent for three years.

The director has been in the construction business for 35 years, predominately working in the regional areas including the Southern Highlands. He had a good product, trading on quality and reliability.

After this experience with Kell and Rigby he was angry, becoming more cynical and nervous. His wife had a nervous breakdown, they sold their furniture and family home in the Southern Highlands. The director and his wife sold their possessions so they could pay the people they owed. The company had 15 employees, suppliers and subcontractors, all who were paid what the company owed them for work and materials supplied. To ensure that he could pay his debts quickly, he sold his house with a \$350,000 discount. The company director and his wife moved to Tamworth. He has managed to keep his business going and still manages to engage an apprentice, labourers, carpenter and foreman – “never been afraid of work”. While living in Tamworth, the work is in Sydney.

The company director has changed the way that he conducts his business, to protect his interests. He asks for and receives 5 per cent deposit. However the key to ensuring that he gets paid for his work, is that payments are held in a trust fund. Progress claims are made every 30 days and he is paid within seven days. That money is released from a trust. Anything that is in dispute is dealt with separately. Retention money is also held in trust.

“It works” he said.

Case Study 7 - referred by the Office of the Small Business Commissioner

‘Company G’ - Concrete Cutting Business

‘Company G’ is a family run concrete cutting business operating in the Wollongong and surrounding regional areas. The business did a job in the St Georges Basin area. After a referral from another local concrete cutting business, the company performed work on the site valued at \$3,500. As per its standard business practices, the business sent an invoice for the amount to be paid within 30 days. Despite repeated requests to pay, and the fact that a significant number of other subcontractors were similarly out of pocket, the builder refused to pay. At a meeting of subcontractors’ owed money by the builder, client representatives made no commitment to paying subcontractors, simply stating that they had paid the head contractor for the work performed.

The company considered claiming payment under the Security of Payment Act, however the cost of doing so was prohibitive considering the size of the debt owed to them.

The company is aware that the builder submitted false statutory declarations to IGA, stating that subcontractors had been paid.

‘Company G’ is still owed \$3,500.

The builder continues to trade.

Case Study 8 - referred by the Office of the Small Business Commissioner

'Company H' - An Excavation Company

'Company H' were engaged by the same head contractor as the previous case study to perform earthworks on a St Georges Basin project. During work, a number of variations were sought by the head contractor, agreed to by the company and signed off by the onsite 'superintendent' employed by the head contractor. There were a number of disagreements about the amount to be paid on progress payments, however these were settled on and payments received by the company up until the last progress payment. The head contractor refused to pay the last progress payment leaving the company owed approximately \$300,000.

The company took action under the Security of Payment Act, costing them approximately \$20,000. The adjudicator's decision was that the company were owed the money claimed. However a garnishee order had no effect as the head contractor maintained that no money was available to pay. The company is considering whether or not it is viable to commit to further legal action to recover the money.

The Project Manager for the company said that apart from other issues relating to insolvency, there should be a requirement that builders make regular payments to ensure that moneys are paid and cash flow for subcontractors is maintained. He suggests a weekly mandated payment cycle.

'Company H' is still owed \$300,000.

The head contractor continues to trade.

Case Study 9

'Company I' - Concrete Cutting Business

The company was another engaged by the previously referred to head contractor to work on the St Georges Basin project. The work was performed over the three months from January to March 2012. The owner repeatedly approached the foreman on site about payment for the work performed and also drove to the Sydney headquarters of the company to demand payment. The owner also approached his local member and the CFMEU for assistance. He is still owed \$6,500. The company simply refuses to pay the money and continues to operate.

The owner also told the Inquiry that he lost money on a St Hilliers job. He was contacted on a Friday and committed to doing the work on the following Tuesday. The company went into voluntary administration the day after the subcontractor completed the work. The owner is adamant that St Hilliers were engaging subcontractors knowing full well that they were in financial trouble and would not be able to pay their debts.

The owner stated that in relation to these examples and others that the dispute always arose on the last payment for the job. It is his belief that the industry is getting worse in terms of operators who simply refuse to do the right thing.

Case Study 10

'Company J' - referred by the CFMEU

The owner of 'Company J' was contracted to work on three projects in the Wollongong area for Perle Constructions.

Perle Constructions went into liquidation in February 2011. The owner states that subcontractors in the Wollongong area are owed in the vicinity of \$2.5 million while he is personally owed \$190,000 for work performed under contract to Perle.

The owner is concerned that government awards the work to the cheapest bid. On a government construction site (engaged for bricklaying), the owner was told by the builder that he (the builder) had never allowed for masonry work in his tender – he didn't know what masonry was. Prior to this government contract, the builder had only ever worked on fit out jobs. The owner wonders why a company with no relevant experience can win government contracts worth tens of millions of dollars. 'Company J' had bid for this work and as part of the bid process, outlined his 25 years experience in the industry.

The company was engaged by St Hilliers in March 2012 to work on a government contract. The owner states that he simply cannot understand why St Hilliers were allocated this work, given that the industry was fully aware that the company was a risky proposition.

In May 2012, St Hilliers were placed into voluntary administration.

The owner has also been affected by the collapse of Kell and Rigby. The company have lost \$19,000 in progress payments for a job in Moss Vale and \$21,000 in retention money for a job in Liverpool. In relation to retention funds, the owner found that Kell and Rigby could not account for this money in its accounts. The owner questions why moneys paid to real estate agents for the purchase of a property must be placed into a trust fund, however in the building industry it is simply not accounted for and can be spent by the builder. In the event of insolvency, such as Kell and Rigby, the money has simply gone. The owner now only uses bank guarantees which he notes are a cheaper alternative to putting up cash money and using his bank overdraft to pay his own bills. He now will not contract with a builder who refuses a bank guarantee – sends off alarm bells that indicates cash flow is an issue.

In his view, shared by others in the industry, Perle Constructions was a façade – it was all based on hire purchase arrangements.

The owner's experience with builders not paying is not confined to Government contracts, having been owed in excess of \$500,000 in jobs across the Sydney suburbs of Marrickville, Wollongong and Dee Why. These jobs all involved a particular company. In the Marrickville development, the owner was successful in negotiating an outcome with the client, who ensured that all subcontractors were paid.

Case Study 11

'Mr X'

Mr X has worked for a number of construction companies including Kell and Rigby. He stated that when he was working for Kell and Rigby four years ago they were \$9 million 'behind' and chasing money. On a significant job in Paddington Green they lost \$7 million and a further \$3 million on a development at Mt Panaroma. Mr X stated that Kell and Rigby could have gone under years ago, however they decided to keep going and ensure that cash flow kept them afloat.

In relation to government procurement, Mr X could not understand why government agencies accepted bids that they had to know were less than the estimated cost of the project.

Mr X stated that it was his view and experience, that a number of project managers and other employees of large building companies make the decision to go into business for themselves. Typically he noted, they last one failed job. These 'entrants' to the industry in effect 'pinch' jobs from the established industry. In the last few years, especially since the cessation of federal national stimulus funds, margins are considerably tighter and the extra competition leads to lower margins and greater exposure to risk.

In his experience Mr X considered that the Queensland system regulates the industry far more effectively. Mr X noted that there was no licensing system for commercial builders in NSW and that for commercial jobs in Queensland, the builder is rated for jobs of a certain value. This, Mr X advised, had the effect that builders are competing against similar builders for work – their overheads are similar, they engage similar people – ie project managers etc.

Mr X also noted the practice of some builders engaging subcontractors on 90 to 120 payment cycles and argued that the NSW Government is creating this type of environment by "throwing meat into a tank filled with sharks".

In relation to retention money, Mr X advised that in his experience, if he had to pay a subcontractor he would, even if that meant using the retention money of a different subcontractor. Mr X referred to this type of scenario as the "false economy of retention money". "It's the done thing" "Something should be done about retention".

Mr X stated that progress payments from client to head contractor are used for all sorts of different purposes – investing (fixed term accounts) – making money off money, paying off other jobs. When project managing for construction companies, Mr X stated that when operating at or close to zero margins, he did what he had to do. This would include signing 'cheaper' subcontractors with lower overheads and avoiding union workplace agreements.

Mr X also noted that during better economic times in the construction industry, margins of 6 per cent were realistic. However when compared to many other industries, this is not a high level of profit.

Case Study 12

'Company K' – A Plumbing Company

'Company K' is a Coffs Harbour based company specialising in industrial, commercial and domestic plumbing. The company was contracted by Perle Constructions to work on three government projects. In its negotiations with Perle, the company advised that if the payment terms were not met, work would cease. Perle failed to make the first payment according to the terms of the contract, and the company promptly ceased work. Subsequent payments were made on time until 31 December 2010. Perle went into voluntary administration in January 2011 and into liquidation in February 2011.

The company were owed \$300,000 for the last progress payment and retention money. In response to losing the retention for each of the three projects, the company now insist on using bank guarantees. They note though, that clients are now offering a choice to contractors – cash retention or bank guarantees. However where subcontractors lose the most money is not through retention, but rather through non-payment of progress payments.

The company is concerned that the principal contractor engaged by the NSW Government, took no responsibility for the outcomes and consider that Perle would not have been engaged if adequate checks had been made.

On this same issue of accountability, the company believe that the government as client must take responsibility. They claim that Perle submitted false statutory declarations to claim payments and that there was simply no enforcement activity.

To compound matters, the work was taken on by St Hilliers, a company that only a short time later went into voluntary administration.

Rather than see any new requirements, the company representative stated that he thought that the financial assessment and tender process should simply be done properly.

Contractor Survey



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

NSW Government – Inquiry into Construction Industry Insolvency

Inquiry Survey

As a contractor, you and/or your business are responsible for managing and delivering many important infrastructure projects across NSW and play a vital role in the NSW economy. We would like to hear your thoughts on the current issue of insolvency in the NSW construction industry.

To assist the Inquiry and provide an open forum for all, we invite you to complete the following survey questions and give your views. While allotted space has been provided for your answers, should you wish to say more you can attach your answers separately.

Please note that any examples you provide in your survey responses can be changed in order to protect the identity of those mentioned if you so wish.

1. What has been your experience with government procurement and contract administration practices? Please provide examples and reasons for whether it has been a positive or negative experience.



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

2. What suggestions can you make to improve the contractual relationship between the government and the head contractor concerning payments for work?



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

4. One of the possible reasons given for contractor insolvency in NSW has been described as poor financial management skills.
- a) What are your views on this possible cause and what, if any, experiences (in either your own company or that of another contractor) have you had where poor financial management skills arose?
 - b) What strategies can you suggest to improve financial management skills within the industry?

Please provide examples and views.

5. To improve the protection of subcontractors when the head contractor becomes insolvent, the following possible options (amongst others) have been considered:
- a) A mandatory insurance scheme to secure payments to sub-contractors; and
 - b) A discretionary mutual fund to compensate contractors from losses arising from insolvency of a lead contractor.

A mandatory insurance scheme works by providing insurance for events such as:

- head contractor default (insurance taken out by head contractor to protect payments owed to subcontractors);
- cash security/retention repayment (payment of cash security/retention money which is then insured by the head contractor in event repayment is not made); and
- subcontractor indemnity (subcontractor takes out insurance as protection against non-payment by head contractor).

A discretionary mutual fund works by having money paid into a fund pursuant to a set percentage amount of, for example, the project contract value, to provide a mutual fund pool.

What are your views on these possible options? Would you be willing to contribute financially to their establishment and implementation? Please state your reasons either in favour of or against the above possible options.



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

8. Another possible option to protect subcontractors in the event of a head contractor becoming insolvent, is the establishment of a trust account to keep money owing to subcontractors separate from the general funds of the head contractor. Under such a scheme, the principal/owner would pay progress payments into such a trust account; clearly identifying the monies intended to be paid to the subcontractor.

It is suggested that the trust would be managed by the head contractor to hold the subcontractor's money in trust as a means of protecting that money from disappearing in insolvency.

In your opinion, would you consider this option an effective and viable protection for subcontractor payments retained by the head contractor? Please state your reasons either in favour of or against the above possible option.



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

9. What factors do you believe have contributed to the high number of insolvencies in NSW? What do you believe are the causes for insolvency in the NSW construction industry? Please state your reasons and any examples.

10. Do you believe that the possible options of protection previously described, or any possible option, should also be extended to include those companies that supply materials to subcontractors?



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

The information provided in response to the survey will be used to prepare a discussion paper and also in the formulation of the report to the Minister for Finance and Services.

Confidential Response Information

As part of this survey (and provided on a confidential basis) we ask that you please also provide the following information relating to your company/business:

1. What is the annual turnover?

0-200K

200K-500K

500K-1 Million

1 Million +

2. What is the total number of staff you employ? _____

3. How long have you been in the industry? _____

Name of business: _____

Contact Email/Number: _____

We thank you again for your time taken to complete this survey. Your answers will provide valuable input to the Inquiry's final report and recommendations.

Subcontractor Survey



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

NSW Government – Inquiry into Construction Industry Insolvency

Inquiry Survey

As a subcontractor, you and/or your business form the backbone for many construction projects across NSW and your welfare is vital to the NSW economy. We would like to hear your thoughts on the current issue of insolvency in the NSW construction industry.

To assist the Inquiry and provide an open forum for all, we invite you to complete the following survey questions and give your views. While allotted space has been provided for your answers, should you wish to say more you can attach your answers separately.

Please note that any examples you provide in your survey responses can be changed in order to protect the identity of those mentioned if you so wish.

1. What has been your experience regarding the payment practices of a head contractor to subcontractors? Please provide examples.



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

5. In general, it has been noted that the process of a subcontractor collecting progress payments from a head contractor is not simple or easy. Collection is often impossible when the head contractor becomes insolvent.

a) What has been your experience with collecting progress payments from a head contractor?

b) What improvements can be made to simplify the progress payment process for subcontractors? Please provide examples.



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

6. To improve the protection of subcontractors when the head contractor becomes insolvent, the following possible options (amongst others) have been considered:
- c) A mandatory insurance scheme to secure payments to sub-contractors; and
 - d) A discretionary mutual fund to compensate contractors from losses arising from the insolvency of a head contractor.

A mandatory insurance scheme works by providing insurance for events such as:

- head contractor default (insurance taken out by head contractor to protect payments owed to subcontractors);
- cash security/retention repayment (payment of cash security/retention money which is then insured by the head contractor in event repayment is not made); and
- subcontractor indemnity (subcontractor takes out insurance as protection against non-payment by head contractor).

A discretionary mutual fund works by having money paid into a fund pursuant to a set percentage amount of, for example, the project contract value, to provide a mutual fund pool.

In your opinion, would these be viable protections and, if you think so, would you be willing to contribute financially to their establishment and implementation? Please state your reasons either in favour of or against the above possible options.

9. Another possible option suggested to protect subcontractors in the event that a head contractor becomes insolvent, is the establishment of a trust account to keep money owing to subcontractors separate from the general funds of the head contractor. Under such a scheme, the principal/owner would pay progress payments into such a trust account; clearly identifying the monies intended to be paid to the subcontractor.

It is suggested that the trust would be managed by the head contractor to hold the subcontractor's money in trust as a means of protecting that money from disappearing in the insolvency of the head contractor.

In your opinion, would you consider this option an effective and viable protection for subcontractor payments retained by the head contractor? Please state your reasons either in favour of or against this possible option.

10. What suggestions can you make to improve the contractual relationship between the head contractor and a subcontractor concerning payments for work performed?

11. Do you have any experiences involving you and/or your business and a head contractor becoming insolvent? If yes, please provide further information and examples.

12. What factors do you believe have contributed to the high number of insolvencies in NSW? What do you believe are the causes for insolvency in the NSW construction industry? Please state your reasons and any examples.

13. Do you believe that the options described above, or others, should also be extended to include those companies that supply materials to subcontractors?

14. When pricing jobs for head contractors what, if any, allowance is built into your tender to price the risk of insolvency of the head contractor, late or irregular payments of progress claims and the administration costs of dealing with such problems?

15. If any method of ensuring prompt and regular payment from head contractors to subcontractors was introduced, would this assist you to price the job more competitively?



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

The information you have provided in response to the survey will be used to prepare a discussion paper and also in the formulation of the Inquiry's Report to the Minister for Finance and Services.

Confidential Response Information

As part of this survey (and provided on a confidential basis) we ask that you please also provide the following information relating to your company/business:

4. What type of subcontracting service do you and/or your business provide? (e.g. plumbing, painting, telecommunications, etc)

5. What is the annual turnover?

0-200K

200K-500K

500K-1 Million

1 Million +

6. What is the total number of staff you employ? _____

7. How long have you been in the industry? _____

In the event that we wish to clarify and/or discuss your survey responses further, would you please also provide the name of your business and a contact email/number:

We thank you again for your time taken to complete this survey. Your answers will provide valuable input to the Inquiry's final report and recommendations.

Retention Funds Survey



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

Subcontractors are invited to contribute answers based on their experience of the use of retention funds in the construction industry.

The Inquiry is considering a range of options one of which may involve the quarantining of funds to be paid to contractors or subcontractors out of retention funds.

In your experience in construction:

- Are retention funds a usual feature of contracting?

- What percentage of progress payments are typically extracted for retention?

- What are some of the typical contractual terms relating to retention funds?



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

- What impact does this have on cash flow and the operation of your business?

- Have/do you use an alternative to cash retention such as bank guarantees? Please specify.

- Are there particular costs or other factors that you are aware of that may limit the use of bank guarantees or other options?



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

- What is your experience in recovering retention moneys at the end of practical completion of a project and at the end of the defects liability period?

- Have you accepted part payment of the retention fund after discussion with the contractor?

- Have you lost retention moneys due to the contractor becoming insolvent?

-
- In your experience, how does the contractor account for retention moneys? For example are they isolated from other funds/accounts of the contractor?

- In general what is the time lapse between practical completion, the end of any defects liability period and receipt of retention moneys by you?

- In relation to retention funds, do you support any of the following options?

Please tick as appropriate

Requiring contractors to allow the subcontractor a choice between cash retention and an alternative such as a bank guarantee?

Barring the use of cash retention funds in construction contracts?

Retaining the retention money in a separate bank account such as "Subcontractor Retention Funds" or similar?



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

Thank you for taking the time to complete this survey. Your answers will provide valuable input to the Inquiry's final report and recommendations.



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

Insolvency Practitioners Survey

NSW Government – Inquiry into Construction Industry Insolvency

Draft Survey for Insolvency Practitioners and Legal Professionals

When answering the questions please consider **at least** the following matters:

- Business and credit cycles;
- The client - contractor – subcontractor payment cycle;
- Payment difficulties and delays;
- Whether some construction companies grow too quickly;
- Whether some construction companies are under-capitalised;
- Low profit margins;
- Tendering and procurement practices;
- The competence of certain contractors;
- The extent to which contractors or subcontractors operate through companies or as individuals;
- Management and financial skills or lack of them;
- The extent to which there is compliance with tax laws including in relation to employees and superannuation;
- The extent to which there may be unlawful phoenix conduct of company directors.



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

12. According to recent ASIC statistics the rates of insolvency in the construction industry are significantly higher in NSW than in all other States and/or Territories. Can you try to explain, based on your knowledge and experience, including in other states, why this would be the case in NSW.

13. There may be particular features that arise in relation to the winding up or administration of insolvent construction companies that are relevantly different from other trading companies, for example in transport, manufacturing, retail etc. Can you think of any reasons why insolvency in the construction industry:

a. should be proportionally higher than such other business sectors in the economy?

b. should be viewed differently to insolvency in other business sectors in the economy.

- c. may be due to causes which are unique to the construction industry. If so, what are those causes and please describe each of them in a little detail.

14. In your experience, do you consider that the construction industry is generally compliant with laws in relation to general corporate law obligations, in relation to the conduct of directors, and in particular in relation to insolvent trading, phoenixing, and in the handling of company assets and funds? Do you consider that the industry is also generally compliant with laws concerning federal and states taxes, worker health and safety, environmental requirements and so on?



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

Do you consider that the industry is properly regulated, in particular in relation to ensuring compliance with corporate and tax laws?

Is non-compliance a contributing factor to insolvency in the construction industry?

Please give your answer in respect of compliance by principals, contractors, subcontractors and, where relevant, employees.



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

16. Do you have any suggestions as to what can be done by the industry itself to reduce insolvencies in the industry and what is often the knock-on effect of such insolvencies?

If so please describe;



INQUIRY INTO CONSTRUCTION INDUSTRY INSOLVENCY IN NSW

The following survey questions are being sent to Contractors. Insolvency practitioners are invited to contribute answers based on their experience.

The Inquiry is considering a range of options one of which may involve the quarantining of funds to be paid to contractors or subcontractors either out of retention funds or in the form of progress payments from the Principal.

In your experience in construction:

- How are retention funds treated in the company's books of account?

- How are they banked?

- How are they styled?

- Does the company use that bank account for general business activities?

- What is the level of subcontractor retention funds retained by the company at any one time?

- \$0k - \$100k
- \$100k - \$300k
- \$300k - \$500k
- \$500k +

- Are such funds invested?

- If so where?

- What has been the typical return on those investments in percentage terms?

- In general what is the time lapse between receipt of progress payments from the principal and payment of progress payments to subcontractors?

- What use is made of that money in that time?

Please tick as appropriate

Payments relating to other jobs?

Retained funds on deposit with a bank or other financial institution?

Retained in a separate bank account styled "Subcontractor Retention Funds" or similar?

Invested in short term investments?

Working capital of the company?

- In the insolvency of the company, have those retention arrangements in fact protected the subcontractors' entitlement?

- Have there been significant legal or other disputes about the status of those moneys?

- Have you found that the requirement to retain funds has had any negative impact on the on-going operations and cash flow needs of the company?

We thank you again for your time taken to complete this survey. Your answers will provide valuable input to the Inquiry's final report and recommendations.

Inquiry into Construction Industry Insolvency

Submission from
NSW Construction Agencies Insolvency Taskforce

Monday, December 17, 2012

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What is the Taskforce?

The Construction Agencies Insolvency Taskforce (the Taskforce) was established in August 2012 by the NSW Government to ensure that government construction projects manage the risk of contractor insolvency effectively.

The construction industry in NSW is facing a period of considerable financial difficulty and has been experiencing a high rate of insolvency. Several high profile government contractors have gone into administration. The Government is concerned about potential consequences for the public sector construction program and the impact this situation is having on industry, including small business sub-contractors.

Key tasks

The Taskforce is meeting initially for a period of six months to review and improve government procurement and contract management processes. In particular, the Taskforce has been asked to:

- review financial assessment guidelines used when selecting contractors and the processes used to monitor financial viability during construction
- identify effective contract management strategies which ensure that contractor payment assurances provided to government are accurate; and
- consider improvements to construction procurement which will reduce insolvency related risks to the Government and to sub-contractors.

The Taskforce is due to report to the Minister for Finance and Services in February 2013 on these tasks, on improvements that agencies have implemented and on further actions that the Government could take.

The Taskforce also has a role of improving communication and coordination across government agencies.

Membership

The NSW Government has a large construction program undertaken by Departments and public trading enterprises including state owned corporations. Taskforce membership is drawn from senior executives of thirteen government agencies with extensive construction expenditure. The Small Business Commissioner is also a member.

Agencies represented on the Construction Agencies Insolvency Taskforce	
<u>Government Departments</u>	<u>Other Agencies</u>
Attorney General and Justice Finance and Services Education and Communities Health NSW Police Roads and Maritime Services Transport for NSW	Endeavour Energy Hunter Water RailCorp Sydney Catchment Authority Sydney Water Transgrid

Formal terms of reference and membership details for the Taskforce are at Appendix One.

Government construction program

The NSW Government is a major source of construction expenditure in NSW. Over the four years from 2012-13 to 2015-16, infrastructure investment will total \$61.8 billion with most of this expenditure resulting in construction work.

In 2012-13, total state infrastructure investment is budgeted at \$15 billion which is approximately \$1.6 billion (or 11.8 per cent) above expenditure in 2011-12. This growth is primarily due to higher expenditure on rail, electricity, health and roads. Major planned projects include:

- upgrades to the electricity distribution and transmission network
- work on the South West Rail Link, North West Rail Link and Northern Sydney Freight Corridor
- extensive water, sewerage and wastewater works undertaken by Sydney Water and Hunter Water
- upgrades of the Pacific Highway and work on the Hunter Expressway, Great Western Highway, Princess Highway, Hume Highway and Central Coast Highway
- extension of the Sydney Light Rail system
- upgrades and redevelopment of major hospitals such as Blacktown / Mount Druitt and Hornsby / Ku-ring-gai
- major school and TAFE projects; and
- new or upgraded police stations at Moree, Riverstone, Parkes, Tweed Heads, Walgett and Coffs Harbour.

Further details of planned expenditure can be found in *NSW Treasury Budget Paper No 4: Infrastructure Statement*, including listed projects by agency.

Due to the extent of its construction program, government procurement and contract management practices have a noticeable impact on the construction industry and can potentially affect how the industry in general manages insolvency risks.

Insolvency in government construction work

The construction industry has experienced an increase in the rate of insolvency in recent years. In 2007-08 approximately 2.6 percent of businesses leaving the construction industry entered into administration. This figure had risen to 3.7 percent in 2009-10. Nationally, twenty percent or more of companies entering into administration are from the construction industry.

Insolvency is a particular problem in the NSW construction industry. Twenty six to thirty percent of all the companies entering into administration in NSW come from the construction industry. NSW also accounts for more than fifty percent of the insolvencies in the construction industry nationally.⁵⁹¹

Data published by the Australian Securities and Investment Commission (ASIC) shows that the main causes of financial failure in the construction industry for 2009-10 and 2010-11 were inadequate cash flow or high cash use, poor strategic management of business, poor financial controls and lack of records, poor economic conditions, undercapitalisation and trading losses. Further information on this research is available in ASIC Insolvency statistics published on the ASIC website.

Government construction work has been affected by this increase in the rate of insolvency, with some notable high profile construction companies going into administration in 2012 including Reed Construction and St Hilliers.

ASIC data does not identify the extent of insolvency for contractors doing government work and the NSW Government does not currently collect this data comprehensively for all sectors of government expenditure. Information available in relation to contractors who are registered in the Contractor Prequalification Scheme administered by the Department of Finance and Services suggests that there have been only a small number of insolvencies amongst prequalified contractors. Data is not presently available for the current calendar year, but in the period from July 2008 to December 2011 there were three prequalified contractors insolvencies reported to the Department. There was no contractor insolvency between 1 July 2011 and 31 December 2011. In the period 1 July 2010 to 30 June 2011 there was one contractor insolvency involving no contracts. In 2009-10, there was one contractor insolvency during the course of construction work involving two government contracts. During 2008-09 there was one contractor insolvency during construction work affecting a minor works contract of small value.

Government procurement framework

⁵⁹¹ Based on ASIC Insolvency statistics – series 1 & 3 and ABS 8165.0 Counts of Businesses, Including Entries and Exits, January 2012.

Construction procurement takes place in the context of the broader government procurement legislation and policy framework.

General procurement framework

Section 149 of the *Public Sector Employment and Management Act 2002* provides that a government agency must obtain value for money in the exercise of its functions relating to the procurement of goods and services of any kind.

The *State Owned Corporations Act 1989* provides that the principle objectives of every State Owned Corporation include operating at least as efficiently as any comparable businesses, and maximising the net worth of the State's investment in the corporation.

Section 9(1) of the *Public Finance and Audit Act 1983* enables the Treasurer to issue directions to officers of an authority who are authorised to commit or incur the expenditure of public money. The *NSW Government Procurement Policy* has been implemented as a Treasurer's Direction. The Procurement Policy applies to all government departments, statutory authorities, trusts and other government entities. State Owned Corporations are exempt although they are encouraged to adopt aspects of the Procurement Policy that are consistent with their corporate intent. The fundamental objective of the Procurement Policy is to ensure that government procurement activities achieve best value for money in supporting the delivery of government services.

The Procurement Policy is supported by a Code of Practice which sets out responsibilities, expected standards of behaviour and required procurement practices including tendering requirements. The Code of Practice makes it clear that the Government will use its position as a major purchaser to only do business with contractors who display a commitment to, and consistent application of, the standards of behaviour outlined in the code.

The Code of Practice does not specifically address insolvency risks, but does establish minimum standards for payments. All parties including government agencies, contractors and subcontractors have a responsibility to consider and finalise claims, payments, retentions and securities in a timely manner. Contractors and sub-contractors have a responsibility to prepare and document claims accurately and to submit claims in a timely manner. Contractors must have reflective clauses in contracts down a contracting chain with sub-contractors, consultants and suppliers which give effect to these requirements.

Tendering Guidelines build on the Code of Practice providing agencies with a structured approach to planning and implementing tendering and associated processes. The Guidelines also provide industry with an understanding of the processes undertaken by NSW Government agencies to ensure fairness and probity in tendering.

Value for money in tendering

Achieving value for money is an important objective for agencies using public funds, including funds used for construction. "Value for money" as referred to in the NSW

Procurement Policy is a key principle underpinning the Policy and refers to the benefits achieved compared to whole-of-life costs. However, value for money does not necessarily equate to 'the lowest price'.

Tendering Guidelines for NSW Government Procurement issued in December 2011 make it clear that NSW Government agencies must specify tender evaluation criteria in tender documentation and then apply those criteria when evaluating bids. Selecting a tender is not undertaken only on a price basis, but is undertaken in accordance with the published evaluation criteria. This commonly involves applying multiple criteria not related to price.

The guidelines specify that agencies must take account of the following when choosing the best value for money tender:

- whether the tender is subject to qualifications or fully meets the requirements of the RFT documentation
- relative agency costs additional to the tender price such as life-cycle and operational costs; and
- any extra value offered such as better quality, better capacity, better management, early delivery or earlier completion.

Individual agencies have procedures and selection methodologies designed to implement these requirements and which provide a range of further detailed guidance on techniques for ranking bids against multiple criteria.

The evaluation methodologies used by the Department of Finance and Services are an example which demonstrates the range of techniques that are used. The Department's Tendering Manual makes it clear that deciding whether a bid gives the best value for money involves a number of factors where price and non-price criteria are weighted and scored.

Construction tender practices also commonly use a "two envelope" technique. An initial assessment of tender bids is made on the basis of non-price criteria. A second envelope holds the price of bids and this is only taken into account in the assessment process after technical and other aspects of a bid are assessed.

Assessment of risk

Agencies conduct a standardized Risk Profile Assessment at the commencement of the planning phase for every capital works project or program valued at \$1 million or above. The assessment generates a score that indicates whether procurement involves a high, medium or low level of risk. The Risk Profile Assessment is part of the information considered when bids for capital funding are assessed. A mandatory independent Gateway Review is required at the business case stage for all high risk procurements or all other procurements valued at \$10 million or more. The purpose of the Gateway Review process is to independently assess whether an appropriate level of discipline is applied across the procurement cycle.

Construction procurement framework

The Department of Finance and Services maintains a *Procurement System for Construction*. Agencies with an extensive construction program and appropriate skills can be accredited to conduct their own procurement. Non-accredited agencies must use the Department's procurement system. Some accredited agencies also choose to use this system.

The agency accreditation scheme for construction applies separately to the planning and delivery phases of construction procurement. For example, an agency may be accredited to undertake planning without support, but be required to obtain support for the delivery phase. A non-accredited agency can obtain "partial" accreditation for a phase of a specific project or program assessed at low or medium risk. Non-accredited agencies can also undertake planning work on a low risk project with a value of less than \$50 million.

The *Procurement System for Construction* provides a structured approach to procurement covering aspects such as:

- selection of appropriate procurement and contracting strategies
- nomination of an appropriate Principal in the contracts
- preparation of tender documents and contracts based on standard forms
- selection of contractors and consultants
- effective management of contracts, including clause commentaries, sample letters and checklists
- maintenance of an effective performance management system through monitoring and reporting; and
- resolution of contractual claims and disputes.

The Department of Finance and Services provides advice on the use of the system to agencies and their advisers through NSW Procurement. The Department can also provide contract management services through NSW Public Works.

Construction contracts

The type of contract used for government construction projects varies according to the type of project, the extent and nature of risks associated with the project, timing of the project and the project funding basis. Contracts for construction cover a variety of options for the design and maintenance phases of the project life cycle. Other contract options include appointing a managing contractor who usually operates on the basis of a tendered management fee with bonuses for delivery early or below estimated cost. Some larger construction projects may be undertaken on the basis of an alliance contract – essentially a joint venture between government and other parties – or a variety of privately financed projects.

Allocating risk in a contract is a key factor in determining the type of contract that is used. Where risk is not allocated and priced appropriately between the agency and the contractor problems can develop, potentially resulting in contractor financial stress.

Guidance in the *Procurement System for Construction* identifies the importance of effectively identifying and pricing risk when a contracting strategy is chosen. This guidance stresses that allocating risk to a contractor that can not be realistically priced may lead to the contractor inadequately or inappropriately allowing for the risk, particularly where competitive tendering is concerned. This potentially can result in the contractor experiencing financial difficulties and possibly insolvency.

Standard form contracts

The majority of government construction contracts issued are for small to medium sized projects where the contractor is responsible for construction and to varying degrees is also responsible for design.

The *Procurement System for Construction* provides standard contracts suitable for these types of project. The GC21 Contract is used for projects with a value of \$1 million or more. Simpler contracts are used for minor works less than this value. Standard contracts are also used for consultancy services and for project management.

The *Building and Construction Industry Security of Payments Act 1999* applies to construction contracts that government agencies enter into as a client and to contracts where a government agency – such as NSW Public Works – is providing contract management, consultancy or other services. This includes provisions in the Act affecting rights to progress payments, claim and payment periods, adjudication of disputes and obligations of principal contractors. Appendix Two provides further information about the operation of this legislation.

Prequalification schemes

NSW prequalification scheme

The Department of Finance and Services maintains a *Contractor Prequalification and Best Practice Accreditation Scheme for Construction*. This scheme is used to support the selection of suitable contractors for work commissioned by non-accredited government agencies and can also be used by accredited agencies and State Owned Corporations.

A contractor can seek prequalification for building work, fitout and refurbishment or for civil works. An applicant must demonstrate that they have a sound business structure, financial capability, necessary resources and managements systems. Recent experience and performance history is taken into account. The applicant must have traded successfully for a minimum period of 3 years before being eligible for prequalification.

Prequalified contractors must accept standard conditions of accreditation. These conditions include immediately informing the Department of Finance and Services of any substantial change in their financial capacity, technical capability and ownership status.

Contractors must have a minimum annual turnover of \$1 million and also identify the financial ranges of contracts for which they are seeking prequalification. Three levels are available. The table on the following page sets out the levels and financial capability requirements for each level.

A contractor prequalified for work valued at more than \$2.5 million can seek accreditation as a best practice contractor. Best practice status can give the contractor preference in tenders. Eligibility requirements focus on the management systems that the applicant has in place. The requirement for net tangible assets is increased from 5% of contract value to 7%.

National prequalification schemes

A national pre-qualification scheme for non-residential building applies to work where the contract value is estimated to be \$50 million and above. This scheme is operated under the auspices of the Australian Procurement and Construction Council on a mutual recognition basis. A contractor applies for prequalification with a participating jurisdiction, such as New South Wales. If accredited, the contractor can apply for recognition in any other participating jurisdiction. A separate, but similar national prequalification scheme is operated under the auspices of Austroads for Civil (Road and Bridge) Construction.

Financial requirements for contractor prequalification

Contract Value	Net Tangible Assets	Current Assets Ratio	Working capital
NSW prequalification			
\$500K to \$1 million	\$50,000	1	\$100,000
\$1 million to \$10 million	\$500,000	1	\$1,000,000
\$10 million to \$50 million	5% of contract value	1	10% of contract value
National prequalification			
\$50 million or more (limited to 100% of average of the previous 3 years financial turnover)	5% of average of the previous 3 years financial turnover	1	10% of value of total financial capacity

Net tangible assets is defined as total assets less total liabilities less intangibles.

Current assets ratio is the ration of current assets to current liabilities.

Financial assessment of contractors

The NSW Government Tendering Guidelines emphasise the need to assess the financial capacity of a proposed contractor when there is a significant risk to the project in the event of financial incapacity. This assessment is additional to the assessment of a contractor's financial capacity for prequalification.

Government agencies, local governments and other public bodies, as well as community not-for-profit organisations, can use financial assessment services provided under State Contract 702055 to assess tender participants. Assessment reports are used extensively for construction projects. In the period from 1 July 2011 to 31 December 2011 there were more than 500 assessments prepared for tender reports.

This State Contract is currently being reviewed with a view to modifying the nature and scope of the assessment services provided. These expected changes are discussed in more detail in the section below on current Taskforce initiatives.

Trust accounts

Clause 33 of the standard government construction contract GC21 Edition 2 requires a contractor to hold in trust any cash securities provided by subcontractors and payments made by the principal which are due to a subcontractor or supplier - and which have not been paid. The contractor must pay this money into a trust account in a bank the next business day after it is received and it must be held in trust until it is paid to the party entitled to receive it. Equivalent provisions were previously included in the standard subcontract issued under GC21 Edition 1 for work worth more than \$25,000. Enforcement was a matter between affected subcontractors and the contractor. Under the current edition of the GC21 contract, enforcement has become a matter between the government agency as principal and the contractor.

The effectiveness of the trust accounts in providing practical protection for money due to a subcontractor in the event of contractor insolvency has not been fully tested.

One agency represented on the Taskforce has gone beyond the trust account requirements in GC21. For selected projects where there is a managing contractor, arrangements have been used where the principal has made contracted payments directly into a trust account.

The Taskforce is actively exploring further options with the use of trust accounts to protect subcontractor payments and to reduce payment times. These initiatives are discussed below in the section on current Taskforce initiatives.

Payment verification

The trust account provisions in the standard construction contract GC21 are supplemented by requirements that a contractor provide a statutory declaration that they have complied with those requirements. Clause 58 requires a contractor to provide a completed and true statutory declaration executed the day a payment claim is made which declares that:

- all subcontract security held in the form of cash is held in trust by the Contractor
- where the contractor has received payment for, or on account of, work done or materials supplied by a subcontractor and has not paid the subcontractor the whole amount to which the subcontractor is entitled under the subcontract, the difference is being held in trust for payment for work done or supplied; and
- all money was deposited into a trust account in a bank no later than the next business day after receipt and will be held for whichever party is entitled to it, until payment is made to that party.

The statutory declaration is made under the *Oaths Act 1900* and it can be an offence under section 25 or 25A of that Act to wilfully and corruptly make a declaration, knowing it to be untrue in a material particular.

The Taskforce is not aware of circumstances where a prosecution has been initiated for provision of a false declaration provided under a government contract. The Taskforce, however, notes that the declaration does not provide any information about any extension of a payment period which may have been negotiated with a subcontractor – instead of making a payment. The Taskforce also notes that the Inquiry Into Construction Industry Insolvency has received criticisms about the validity and effectiveness of statutory declarations provided under other contracts in private industry.

The Taskforce is considering actions that could potentially improve the veracity of payment assurances provided under government contracts. This is discussed in further detail below.

Current Taskforce initiatives

The Taskforce has developed a work program to address its terms of reference and to report to the Minister for Finance and Services in February 2013. The initial focus is on improving financial assessment processes, identifying contracting strategies which reduce insolvency risks – such as more effective use of trust accounts where they exist and establishing improved processes for interagency coordination.

Financial assessment

Standard assessment reports

The Taskforce has agreed that consistent standards should be implemented across government agencies for the financial assessment of tendering parties. The Taskforce is working with the Department of Finance and Services to implement agreed templates for financial reports. The Taskforce anticipates that three levels of reports may be used,

depending on the size of the contract and risks associated with the project. These standard financial reports will be implemented initially through the *Procurement System for Construction*.

State Contract 70205 which provides financial assessment reports is currently being reviewed. The Department of Finance and Services anticipates updating this contract to ensure that service providers prepare financial assessments which are consistent with the standard financial reports being developed for the *Procurement System for Construction*. It is expected that the new standard reports will provide more extensive assessments than current reports, particularly for larger contracts. Guidance is being prepared for agencies using the revised financial reports to assist the transition to the new standards.

Non-accredited agencies which use *Procurement System for Construction* will use the standard financial assessment reports provided under the updated State Contract 70205.

Central repository of financial assessment information

Agencies currently obtain financial assessments individually - on an "as needs basis". Information is not routinely shared across government agencies. As a consequence:

- financial risks for a company identified by one agency in a tender process may not be communicated to other agencies which have existing contracts with that company
- processes for monitoring the ongoing financial status of a contractor with more than one concurrent job may be replicated across multiple agencies; and
- multiple financial assessments for a company may be prepared within a very short timeframe where the company is submitting tenders for multiple jobs, resulting in unnecessary costs for agencies and the company.

The Taskforce has agreed that the Department of Finance and Services will establish a central repository of financial assessment information which will be accessible to agencies during the tendering process.

Guidance and training

The Taskforce recognises that the introduction of standard assessment reports will require training for agency staff involved in tender specification and assessment. Effective ways of ensuring that the relevant skills are developed will be considered as part of the implementation process.

Payment Timeframes and Assurances

The Taskforce has identified the need to implement enforceable requirements for fair payment to sub-contractors working on government projects. Payment requirements in the standard GC21 contract are being reviewed along with conditions for prequalified contractors under the *Contractor Prequalification and Best Practice Accreditation Scheme*

for Construction administered by the Department of Finance and Services. The changes being developed are designed to:

- ensure that government contracts provide for regular payments and have payment periods for subcontractors which do not exceed 30 days
- ensure that the payment process is transparent and provides certainty for parties at every level of the supply chain about how much and when they will be paid
- require contractors to accurately report payments made to subcontractors and any agreements made with subcontractors to extend or reschedule payments for work done
- make it clear that non-payment or deliberate late payment or unjustifiable withholdings is unethical and a breach of contract; and
- confirm that statutory rights under the *Building and Construction Industry Security of Payment Act 1999* must be honoured.

The Taskforce has reviewed the existing requirements for statutory declarations in the GC21 contract and has agreed that these provisions need to be improved. The Taskforce is assessing alternative strategies for obtaining reliable payment assurances including options for more effective enforcement through contractual provisions and criminal sanctions.

Project trust accounts

The Taskforce has examined the operation of project bank accounts in the United Kingdom and is considering the potential benefits and costs of implanting similar arrangements for trust accounts for NSW Government construction work. In considering the example provided by the United Kingdom, the Taskforce has noted that further evaluation of the effectiveness and impact of trust accounts needs to be undertaken in the Australian context.

Particular aspects which need to be understood include:

- the administrative costs of trust accounts
- whether it is practical to implement trust accounts and related administrative processes for the third tier of sub-contractors and for material suppliers
- whether trust account arrangements are compatible with all forms of contracting – for example can they be effectively implemented for an alliance contract
- what impact shorter cash flow cycles will have on the financing of projects, particularly for principal contractors
- whether project costs are increased
- the extent of any reduction in client administrative costs due to more effective and transparent payment assurances; and

- whether it is appropriate for the principal to be separated from any trust structure.

Trial of trust accounts

As discussed above, the second edition of the GC21 contract includes requirements for a contractor to establish a trust account. The contractor must hold in trust any cash securities provided by subcontractors and payments made by the principal that are due to a subcontractor or supplier and which have not been paid.

The Taskforce is assessing whether additional arrangements need to be implemented to ensure that funds in any such trust account are protected in the event of insolvency. Further changes to the GC 21 contract are being considered including mandatory requirements for a trust deed. Possible contractual provisions are being developed to supplement the existing GC21 contract and evaluation criteria are being established.

Improved coordination and information sharing

Information sharing has been a key aspect of the initial work of the Taskforce. A range of informal information networks have operated previously. This has been supplemented by a quarterly meeting of senior operational managers across government through the Construction Consultative Committee.

The Taskforce has implemented more formal arrangements. The Taskforce collated information on construction contracts issued in the previous 18 months and circulated this to all members. This provides a base set of shared information on existing and recent construction contracts which agencies can use when assessing new construction bids.

Most agencies involved in the Taskforce currently use the NSW E-Procurement system to publish information on tenders and contracts awarded. The Taskforce has agreed to use this system as the basis for identifying previous contracts and contracting agencies when assessing new contract bids. Some agencies publish tender and contract information outside of the E-Procurement system. These agencies have agreed to provide a monthly listing of new construction contracts to other Taskforce members.

Industry information campaign

The Taskforce has noted that the Government requested that the Department of Finance and Services facilitate an information campaign for the construction industry on credit management and insolvency. The proposed information campaign is consistent with proposals being considered by the inquiry to improve industry financial skills. The taskforce welcomes these initiatives, but recommends that the timing should be coordinated with implementation of changes to government procurement and any changes arising from the inquiry recommendations.

Further information

The inquiry is invited to seek further information on any of these initiatives and on current procurement arrangements for government construction.

Further information can be obtained from Michael Bardsley, Manager (Policy and Research), Policy and Executive Services, Department of Finance and Services, phone 9372 9242 or email Michael.Bardsley@services.nsw.gov.au

Appendix One: Terms of Reference for Taskforce

The construction industry in NSW is facing a period of financial difficulty and has been experiencing a high rate of insolvency. Several high profile government contractors have gone into administration. The Government is concerned about potential consequences for the public sector construction program and the impact this situation is having on industry, including small business sub-contractors.

The Government has asked the Department of Finance and Services to establish a taskforce of major construction agencies. This taskforce will provide a mechanism to improve the current management of existing government construction contracts and to ensure that future procurement activity incorporates effective risk management strategies.

The taskforce will initially meet for a period of six months to review and improve government procurement and contract management processes. The taskforce will also provide an ongoing mechanism to share information and ensure coordination in the management of contractors known to be at financial risk. Specifically the taskforce will:

1. Review financial assessment guidelines used in the selection of prequalified contractors and the processes used to monitor the ongoing financial viability of contractors during construction.
2. Identify effective contract management strategies which ensure that payment assurances provided to government are accurate. Without limiting options, strategies which will be considered include:
 - (a) modifying government contracts to provide a more open book view of contractors financial arrangements with sub-contractors
 - (b) implementing project trust accounts similar to those used for government construction work in the United Kingdom; and
 - (c) enforcing criminal sanctions for providing false information, including statutory declarations – with consideration of specific new offences if this is necessary.
3. Taking account of the government's broader procurement reforms, consider other possible improvements to construction procurement which will reduce insolvency related risks to government and sub-contractors.

4. Share information across agencies about the performance of contractors undertaking government work and ensure coordination between agencies in the management of contractors known to be at financial risk.
5. Report to the Minister for Finance and Services within six months on the outcomes of terms of reference 1, 2 and 3. This includes reporting actions taken by agencies to implement improvements and any recommended actions that the Government could take to make further improvements. The Taskforce will also report on the outcomes of its information sharing and coordination role, including risks that have been reduced and recommendations for future whole of government coordination.

Taskforce Membership (as at 9 October 2012)

Name	Agency	Position
Anthony Lean (chair)	Finance and Services	Deputy Director General, Policy and Executive Services
Richard Allan	RailCorp	General Manager, Strategic Procurement & Supply
Brian Baker	Finance and Services	Deputy Director General, Public Works
Jenny Birch	NSW Police	General Manager, Strategic Procurement & Fleet Services
Bob Broadfoot	Hunter Water	Manager Contracts
Bevan Brown	Transport for NSW	A/Deputy Director General, Transport Projects
Michael Gatt	Transgrid	Executive General Manager, People, Strategy and Corporate Services
Yasmin King		Small Business Commissioner
Peter Letts	Roads and Maritime Services	A/Director, Infrastructure Development
Kerry Marshall	Attorney General and Justice	Director, Asset Management
Franz Schlechta	Endeavour Energy	General Manager Strategic Procurement
Ian Payne	Sydney Water	General Manager, Infrastructure Delivery
Tony McCabe	Education and Communities	Director, Planning and Delivery Asset Management Directorate
Robert Rust	Health Infrastructure	Chief Executive
Terry Stevens	Sydney Catchment Authority	Senior Manager, Procurement
Peter Wellings	Roads and Maritime Services (alternate member)	General Manager, Infrastructure Contracts

Appendix Two: Building and Construction Industry Security of Payment Act 1999

Security of Payment

The *Building and Construction Industry Security of Payment Act 1999* was enacted in New South Wales to reform payment behaviour in the construction industry by ensuring that any person who carries out construction work (or supplies related goods and services) under a construction contract in New South Wales is provided with (a) a statutory right to progress payments in respect of that work; and (b) access to an adjudication procedure where the amount of such payments can be determined on an interim basis and enforced immediately, without prejudice to the rights of parties to have disputes determined finally and conclusively in accordance with ordinary court or arbitral processes.

Adjudication determinations are interim in nature meaning that the parties' common law rights under their contract are preserved allowing litigation or arbitration at the conclusion of the contract to recover any surfeit or shortfall. Any progress payments made as a result of an adjudication determination are taken into account when a final order or award is made. The emphasis of the Act is on maintaining cash flow. It is a system of 'pay now, argue later'.

The New South Wales Security of Payment Act commenced in 2000 following a number of reviews of payment practices in the construction industry, including reviews by the Independent Pricing and Regulatory Tribunal and the Joint Standing Committee on Small Business in 1998, and in response to general concerns about the difficulty faced by subcontractors in recovering progress payments from principals and the need to ensure cash flow across the industry. All other Australian jurisdictions have implemented security of payment legislation.

Amendments to the Building and Construction Industry Security of Payment Act 1999

From 28 February 2011, if a subcontractor applies for adjudication under the Building and Construction Industry Security of Payment Act 1999, they are also able to issue a Payment Withholding Request to a principal contractor. As a result of that notification, the principal contractor is required to retain the amount of the claim from any money owed to the respondent.

Under the amended Act, principal contractors must retain unpaid money to the value of the adjudication application until one of the following occurs:

- The adjudication application for the payment is withdrawn;
- The respondent makes payment to the claimant under the payment claim;
- The claimant serves a notice of claim on the principal contractor under the Contractors Debts Act 1997
- A period of 20 business days elapses after a copy of the adjudication determination is served on the principal contractor by the claimant.

There are penalties for principal contractors if they do not comply with these requirements.

Monitoring performance of the adjudication system

The Government now has reliable data and analysis showing the detailed performance of the New South Wales statutory adjudication system. In August 2011, the Department of Finance & Services formed a partnership with the Faculty of the Built Environment within The University of New South Wales to establish the Adjudication Research + Reporting Unit ('the ARRU') to undertake and to report on research on key aspects of security of payment in the building and construction industry. This collaboration has yielded regular progress reports on adjudication activity in New South Wales based on data provided by the Authorised Nominating Authorities. Quarterly Adjudication Activity Reports covering the financial year ending June 2012 are published on the [NSW Procurement](#) web site.



Final Report

Inquiry into Construction Industry Insolvency in NSW
