DISCUSSION AND ISSUES PAPER

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Inquiry into Construction Industry Insolvency in NSW

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TABLE OF CONTENTS

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Introduction

This Discussion and Issues Paper deals with the subjects in the order in which they appear in the Terms of Reference. The Inquiry's Terms of Reference are attached in the appendices section of this paper and together with other documents may be accessed at: http://haveyoursay.nsw.gov.au/construction-industry-inquiry

One of the principal purposes of this Paper is to obtain information from readers concerning the legal, practical and financial effects of any proposed options that may be recommended to the government, so that this evidence may be considered by government when weighing and balancing the social, economic, financial and political consequences of various proposals.

The suggested use to be made of the Paper is important. It is intended to operate as a lightning rod to attract further evidence, opposition and/or support for the various alternatives under discussion and to give an opportunity to readers to make any new suggestions which they think should be heard in addition to the range of proposals currently under examination.

The Inquiry has actively sought continuing contributions from all parties in the contracting chain from the principal/owner through to head contractors, subcontractors and suppliers. The Inquiry recognises the importance of engaging the different sectors within the construction industry and to this effect has sought and received submissions from companies, individuals and organisations representing the commercial, cottage/residential and civil sectors, as well as senior representatives of government agencies that contract in the construction industry in NSW. The contractors that have made contributions range from publicly listed construction companies referred in the industry as 'tier 1', through to large private companies operating in the 'tier 2' category. Importantly, the Inquiry has also heard directly from the smaller builders operating in the commercial and residential sectors and from subcontractors of varying size.

At the time of release of this Paper, the Inquiry has:

- Conducted more than 50 meetings with builders, subcontractors, barristers, solicitors, arbitrators, engineers, mediators and adjudicators specialising in construction matters, insolvency specialists, accountants and other financial professionals, peak industry associations and a number of Government regulators and departments;

- Distributed more than 500 surveys to head contractors and subcontractors;
- Liaised with the UK Cabinet Office to discuss the work of the UK Government in this area and in particular the operation and effectiveness of Project Bank Accounts (discussed in another part of this Paper);
- Discussed the cost and practicality of mechanisms such as Project Bank Accounts to protect subcontractors interests with the Commonwealth Bank of Australia and Westpac;
- Researched the UK, US and Canadian experience of construction trusts and other formal mechanisms to protect subcontractors interests that operate in those countries;
- Researched the position in the other Australian States and Territories (discussed in another part of this Paper);
- Held teleconferences with leading US and Canadian construction law practitioners and academics;
- Considered the findings and relevant material from other inquiries that have considered these and/or related issues;
- Received more than 90 submissions and surveys from individuals and organisations; and
- Conducted detailed question and answer sessions with another 50 representatives from all sectors of the industry.

The work and expertise of the Industry Reference Group has also been an invaluable source of information and advice to the Inquiry. Membership of the reference group is detailed in the appendices section of this Paper.

The Small Business Commissioner has raised a number of important issues which the Inquiry will continue to consider.

The Inquiry's approach thus far

Two overarching considerations have informed the approach that this Inquiry should take. The Inquiry has concluded that no single recommendation is likely to achieve the desired objectives of the Government and that the prospects of effective reform are maximised if an integrated approach is taken to a range of potential solutions. Possible solutions to the complex problems raised in the Terms of Reference should not be piecemeal.

The same reason in principle, requires that the role of the owner/principal, whether engaged in the private or public sector should also be examined. It is both illogical and wrong to consider the problems raised in the Terms of Reference as if they intersected with only one link of the contracting chain.

This in turn may lead to expression of a number of fundamental principles concerning the role of Government. The successful utilisation of Project Bank Accounts (PBAs) in public sector construction in the United Kingdom has for example, presented the New South Wales

Government with an opportunity to carefully consider the way in which that system operates and to examine its effects upon tendering practices generally, contracting practices and each of the subjects generated by the Terms of Reference. The use of PBAs is one of the measures under consideration by the Inquiry.[1]

The Construction Industry in NSW

The Inquiry is cognisant of the prevailing economic conditions that exist within and outside the construction industry in NSW and the impact these have on not only the level of activity within the sector, but also within the contracting chain. The Final Report to Government will outline key economic indicators and any links to the issues being considered by the Inquiry.

It is also important to note that within the construction industry itself, a number of different markets exist. These markets within the industry are generally described as the commercial, civil and residential sectors and while sharing a number of important features, can be identified as having some unique characteristics. The Inquiry understands that any proposals recommended must be mindful of the particular circumstances and needs of individual sectors, the participants in those sectors, their size and level of sophistication, as well as the existing regulatory requirements. It is also acknowledged that within the different sectors there are some clear differences in behaviour.

Who does the work?

Beginning more than two decades ago, there has been a growing trend of builders gravitating to a role best described as project management rather than overseeing their labour force working on a construction site. This trend has resulted in those who are 'building', are not typically those entities that have a direct contractual relationship with the client. In fact they are the subcontractors engaged by the head contractor, the subcontractors engaged by subcontractors and so on.

The Gyles Royal Commission into Productivity in the Building Industry in NSW (Gyles Royal Commission) conducted a survey of 20 major building projects "….to analyse the performance of a number of large building projects so as to draw conclusions about their overall performance, to catalogue those practices and that conduct affecting productivity across the projects……..".[2]

These projects represented private and public sector clients for residential, commercial office, retail and other builds.

[1] See Terms of Reference 3 (f) of this Paper
[2] P3 Gyles Report Volume 9

As part of its work, the Gyles Royal Commission developed an Issues Paper that considered matters relating specifically to subcontractors noting "…the very strength of the movement towards subcontracting which has created over many years the decline of the master builder and the emergence of the general contractor, and through that entity of the very many options in relation to project delivery which are available".[3]

The Gyles Royal Commission noted the "omnipresent" role that subcontractors played in the construction industry at that time. Across the 20 major building projects surveyed, 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.[4]

The Gyles Royal Commission firmly concluded that most construction work was performed by subcontractors and their employees. All the evidence suggests that this remains the case today. In the meetings conducted by this Inquiry, the widely held belief that subcontractors perform the majority of work on building sites not just in NSW but across the country, was confirmed by participants and representatives from across the industry spectrum.

It follows then, that payments made by the owner/principal to the head contractor as progress payment for work completed was for work overwhelmingly performed by subcontractors and their workforce.

The need to consider payment practices in the construction industry which have changed at least in part due to the change in the way the work is contracted, is clearly set out in the Terms of Reference. As part of this analysis, the management, allocation and avoidance of risk is of fundamental importance to understanding how the industry operates. The Final Report of the Inquiry will go into greater detail on the question of risk recognition, allocation and pricing.

Tendering and Risk

One often hears the expression "value for money" when construction tendering is being discussed. It would seem tolerably clear that in the world of public administration the expression "value for money" may often lead to an award of the contract to the "lowest price" bid. It is necessary to ask the question how and for what purposes is "value" to be measured and what is the amount of "money" concerned. If the automatic reaction on the part of principals was to simply accept the lowest price, nothing more or less would have been achieved than the establishment of a race to the bottom. NSW Government Procurement Guidelines define "value for money" as "the benefits of an expenditure of funds considered

[3] P140 RCBI Volume 9
[4] P141-2 RCBI Volume 9

on the basis of whole-of-life costs and alternative uses of the funds."[5] However the Inquiry has heard suggestions that in real and practical terms, Government agencies' interpretation of the "value for money" criteria is sometimes much restricted, and often, in the view of some, confined to what amounts to lowest cost.

In intensely competitive periods of construction activity such as that in which the industry finds itself at the moment, the effect upon subcontractors of such an approach in either the public or private sector is inevitable. Many witnesses informed the Inquiry that in the present somewhat straightened conditions of the industry, the way in which some contractors sought to remain viable was by "squeezing" the subcontractors and remaining on the lookout for opportunities to exploit the variation clauses in the particular contract. Neither approach is guaranteed success or to produce good outcomes for those in the contracting chain.

The ability to price risk accurately and a commensurate ability to manage that risk, diminishes as one moves down the contracting chain. The Inquiry has heard to date, that it is often the case that those who are least able to manage the risks associated with a construction project, are often those who bear a disproportionate amount of that risk - subcontractors. At a time when contractors and their subcontractors are tendering for and taking on work at, or even below cost, an inability to manage risk can be fatal to an enterprise. One industry representative described 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" [6] 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.

It can be argued that the Government can provide an effective lead in the field of payment practices and adopt an approach to the acceptance of tenders which is likely to lead to a healthier relationship between contractors and subcontractors. While this Paper raises some examples of high profile insolvencies, it is recognised that it is not part of the role of the Inquiry to make findings in relation to specific company failures and to apportion blame for such failures.

Through its work and the analysis of submissions received to date and after numerous meetings with industry stakeholders, the Inquiry considers that an integrated approach to the Terms of Reference may involve either alone, or in combination, some of the following measures:

1) The Construction Trust;
2) An overall contractor licensing system along the lines of the *Queensland Building Services Authority Act 1991*;
3) More thorough checks by principals of the contractors they engage;

[5] http://www.nswprocurement.com.au/Government+Procurement+Fframeworks/Overarching-Procurement-Environment/Tendering-Guidelinesv3-2-27_January-2012aspx

[6] Douglas Greening, Chief Operating Officer, Master Plumbers Association

4) More thorough checks by subcontractors of contractors for whom they propose to work[7];
5) Making retention funds a genuine trust fund in a segregated bank account with two authorised signatories being the contractor and subcontractor;
6) A revision of the benign approach to false statutory declarations emphasising the availability of existing legal remedies to prosecute for breaches of the law;
7) The consideration of amendments to improve the operation of the NSW *Building and Construction Industry Security of Payment Act 1999* (SOPA);
8) A comprehensive standing education campaign; and
9) The introduction of prompt payment legislation.

Not all of the evidence has yet been gathered by the Inquiry and so what follows are not specific findings or conclusions. They are not to be treated as concluded views but merely as an indication of the effects of some of the evidence and to facilitate further discussion.

In setting out that evidence it is not intended to suggest there is no evidence to the contrary.

The Inquiry's Final Report will not only include its recommendations, it will be structured in such a way that alternative choices and the evidence to support those choices are clearly set out to enable consideration by the Government to extend across all of the competing views.

The Final Report of this Inquiry will include recommendations to the Government on what it believes to be the most effective and practical methods to better protect the interests of subcontractors in the construction industry.

Responses to the Discussion and Issues Paper

Responses to this Paper are a vital element in the work of the Inquiry. General responses are invited and specific questions and issues to which readers attention are invited are printed in red.

The evidence taken by the Inquiry so far indicates that there was more than ample justification for the Government to again put the spotlight on problems in the construction industry, particularly those which impact adversely upon subcontractors. The latest Australian Security and Investments Commission (ASIC) statistics on insolvency confirm what the Inquiry has heard directly from those working in the construction industry. That is, businesses in this industry are far more likely to fail than those in other sectors of the economy.

[7] This appears to be the common practice for contractors to conduct financial and other checks of those subcontractors they propose to engage.

The Inquiry has heard evidence of practices of delayed payments, over-bearing attitudes by head contractors towards subcontractors, non-payment, phoenix operations, a reluctance on the part of subcontractors to use the SOPA provisions, gross bargaining inequality, abuse of retention sums and insistence upon long payment cycles in a highly competitive industry where one of the prevailing sports has been described in the tender meetings of one principal contractor as "the subbie squeeze".

SOPA has brought about an improvement for subcontractors, however, the Inquiry has discerned a tendency to overstate the effect of that legislation in the building community, bearing in mind the disinclination at the lower end of the subcontracting stratum to make use of the legislation. On the other hand the Inquiry has been told of many examples of the SOPA provisions being utilised by large contracting firms in disputes with owners.

The problems that have been recounted to the Inquiry are problems which have been ventilated time over for many years. The Inquiry's examination of the Reports of the Gyles Royal Commission into Productivity in the Building Industry in New South Wales (1992) and the Cole Royal Commission into the Building and Construction Industry (the Cole Report, February 2003) and reports of other inquiries in other parts of the world, has demonstrated the remarkably perseverative nature of complaints of this kind. The recurrence of these questions, together with repeated calls for the introduction of something like the statutory construction trust, indicate to the Inquiry that the time is ripe for a decision by Government upon the desirability or otherwise of some methods of reform. Many of these suggestions are not new to this Inquiry and in one form of another, most of them have been made before.

Owner/principals have by and large demonstrated that they can protect themselves in the event of the insolvency of their head contractor but in the less sophisticated milieu of the subcontractor world, there is in truth, no similar opportunity to protect the subcontractor.[8]

Head contractors are also in a much stronger position as against subcontractors.

It was said earlier that one of the principal purposes of this Paper is to obtain information concerning the practical and financial effects of a proposed recommendation in the form of feedback from those who had the opportunity to work through the Paper. Once this has been done the Government will be able to consider not only the Inquiry's recommendations but the response to them from relevant sectors of the community.

Government Procurement

The Inquiry's Terms of Reference in at least two particular respects, call upon it to make some observations concerning tendering and procurement for public contracts. The St Hilliers and Reed Constructions experiences remain a source of trenchant complaint

[8] CBP Lawyers, 'How to protect yourself against the construction contractor's insolvency', 20 September 2012

throughout the industry and it is appropriate to examine some of the questions which have emerged thus far from the fate of these two companies. It is obvious from the comments made by several witnesses, that the Reed Constructions liquidation and St Hilliers voluntary administration, raise questions as to the form, content and efficacy of the evaluation assessment process undertaken by various government departments, when contractors tender upon a public project.

The Inquiry notes that the Government has established a taskforce to review government procurement and contract administration processes. The Inquiry understands that the terms of reference for that taskforce include:

- Reviewing financial assessment guidelines used in the selection of prequalified contractors and the processes used to monitor the ongoing financial viability of contractors during construction;
- Identifying effective contract management strategies which ensure that payment assurances provided to government are accurate; and
- 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 subcontractors.

The Inquiry will consider any material the taskforce provides to it and notes the high importance of the work of the taskforce in the light of what has recently happened.

Any decisions by a principal (whether public or private), to contract with a head contractor which is already under financial stress, may itself put in train a sequence of events. This may include the subcontractors who have contracted with the distressed contractor, themselves becoming insolvent or at least suffering the adverse consequences of the contractor's insolvency. Reed Constructions is an example of such an outcome.

In that way, and to the extent government whilst not being properly described as the *cause of insolvency*, can nevertheless be seen to be a participant in the facilitation of a structure within which a distressed building contractor is given the opportunity to enter into a range of subcontracts at a time when its financial future was doubtful.

The Inquiry was told by the principals of a prominent assessment and ratings agency, of the detailed checks and investigations which that company could carry out for clients, mainly owner/principals, of the financial health of construction companies. Some evidence to the Inquiry has suggested that St Hilliers had no prospect of satisfactorily emerging from such an examination. The cost of a top of the line financial health check by that company is $7000.

The Inquiry discussed the general approach involved in the utilisation of assessment tools of that kind with two senior partners from Pricewaterhouse Coopers. A number of important considerations were put before the Inquiry during that discussion.

Foremost amongst these was the warning that information in the audited accounts of a company is only useful as a means of evaluating the financial position of that company for a period of six months, bringing life to the phrase that "accounting delayed is accounting denied". Thereafter there is an extremely steep erosion of the capacity of that information to be utilised as an accurate barometer of what might happen in the future.

Assessing the risk – the decision to engage

One of the events which lay behind the establishment of the Inquiry was of course the St Hilliers Construction Pty Ltd voluntary administration. Government contracts for the completion of work following the collapse of Perle Pty Ltd in January 2011, were awarded to St Hilliers on 9 March 2012. The Inquiry notes the recent announcement by the administrators of St Hilliers that rather than move into liquidation, the company would attempt to trade its way out of difficulty with creditors being asked to vote on a deed of company arrangement.

On 5 March 2012 an insurance company issued a Credit Limit Decision (CLD) to a subcontractor which had sought debtor's credit insurance in respect of St Hilliers Construction Pty Ltd. In that CLD it was made clear to the applicant company, that there had been a recent review of St Hilliers and the insurance company as a consequence had "….. removed cover on this debtor [St Hilliers] across the board." It was also said that the decision "has not been taken lightly and has been made in light of confidential information received. [The insurance company] have endeavoured to obtain additional information from the group however this has not been forthcoming."

The Inquiry has not yet been able to determine how widespread the knowledge of that CLD was. However what the Inquiry has been able to determine is that by an earlier CLD dated 18 July 2011, after conducting a review of the St Hilliers Group of Companies, the insurance company reduced its exposure by 40 per cent across the board and did not rule out further reductions.

What is of concern to the Inquiry is the apparent ease with which this subcontractor was able to obtain apparently real time valuable information by making a simple credit inquiry, while such information may not have been sought and considered by Government departments. It is troubling that after a decision had been made by one of Australia's largest insurance companies to "remove cover on this debtor across the board" that four days later that same company or at least one of the group of companies should be awarded significant government contracts. No doubt it will become important in due course for the relevant government departments and agencies to inquire why such information readily available to a subcontractor, if it is the case, was not sought or available to the State Government with all of the resources available to it. That said, the Inquiry understands that reports were obtained from another investigations company and it is necessary to examine those additional circumstances before any final view is formed.

That however is not the primary focus of the Inquiry, although a balanced review of the relationship between contractors and subcontractors cannot be completed unless the other vital element in the three-cornered relationship, the principal/owner, is also considered. The reasons for this are obvious. The contractual terms and conditions agreed between the owner and head contractor directly impact upon the assessment and assumption of risk and the extent to which the head contractor attempts to pass that risk on down the line to its subcontractors. In addition, the relationship between the head contractor and the government agencies created through the tender process, places its imprint upon the costing structure and the terms and conditions of the agreement ultimately formed between the Government agencies or instrumentalities and the head contractor. Decisions taken at that level have an inevitable trickle-down effect and to the extent that an examination of those processes reveal deficiencies, and then the possibility that those deficiencies may operate to create their own problems further down the line, they must be acknowledged and where appropriate addressed.

Terms of Reference: Paragraph 1

The extent and cause of insolvency in the construction industry in NSW.

Introduction

Not surprisingly there was no consistent view expressed by those who gave evidence to the Inquiry that one cause, more than any other, explained the disproportionate number of insolvencies in the construction industry in NSW compared with other Australian States and Territories and across other industries. The causes mentioned by witnesses to the Inquiry were:

- Extremely low barriers to entry in the construction industry;
- The operation of recurrent financial credit and business cycles;
- The global financial crisis (GFC), to which a number of witnesses excepted the beneficial effect of the Commonwealth Government Stimulus Package;
- The large number of competing contractors in NSW and a sluggish market demand which has led to intense competition and extremely low, sometimes negative margins;
- A poor appreciation and evaluation of risks by contractors and subcontractors;
- Low capital backing resulting in a diminished ability to ride out "the one bad job"; and
- The collateral application of funds outside the closed payment cycle, for example the application of progress payments to other jobs, development projects and other items of discretionary expenditure.

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. For the construction industry the next most common reason for business failure recorded by ASIC is poor financial control. The Inquiry considers that this is an important consideration.

Extent and cause of insolvencies – the ASIC data

As part of its role in regulating Australian companies, ASIC compiles and publishes legal notices and statistics relating to external administration and deregistration of companies.

On 7 September 2012, ASIC released its annual report of corporate insolvencies, *'Insolvency statistics: External administrators' reports 1 July 2011- 30 June 2012'.* This report provides statistical information in relation to the number of insolvencies and the profile of companies placed into external administration such as employee numbers, the estimated value of unsecured creditor debts and the causes of company failure. The Inquiry has also made use of other data published by ASIC covering previous financial years.

The September 2012 report confirmed previous years ASIC data that showed the construction industry had the single highest number of insolvencies. For the financial year 2011-12, the construction industry accounted for 22.1 per cent of the more than 10,000 insolvencies that occurred across Australia. The next ranked industry is 'retail trade' accounting for 10.2 per cent of insolvencies.

The ASIC data also shows that across all industries, NSW accounts for 44.7 per cent of insolvencies, followed by Victoria at 22.4 per cent and Queensland at 21.1 per cent.

It is noted that the number of insolvencies in the '*Other services*' category marginally outstripped construction in 2011-12. However this category groups together a number of different industries including a broad range of personal services; religious, civic, professional and other interest group services; selected repair and maintenance activities; and private households employing staff (see Australian Bureau of Statistics http://www.abs.gov.au/).

One factor emerging from the insolvency statistics is that a high percentage of insolvencies is made up of small companies. This is not a reason to discount the importance of these insolvencies or the personal impact upon those associated with the companies.

For the period 2011-12, the data extracted from initial reports lodged by external administrators' shows that more than 60 per cent of these companies had fewer than five employees. This data gives some indication of the type or size of company involved in the construction industry, most likely to trade into difficulties and become insolvent.

The ASIC statistics examined by the Inquiry do not provide a breakdown of the sector in the overall industry in which those small companies operate. Even if they did, there may be a movement of such subcontractors between sectors. However what is perhaps more important is the fact that there is not as yet, in any event, any reliable proof that the high rate of

insolvency of such companies was directly related to the insolvency of a head contractor owing money to the small subcontractors in this group.

For that reason the Inquiry would like to receive as much further information as possible concerning the small subcontractor insolvency problem.

Advice from the NSW Small Business Commissioner that the ASIC figures are "likely to be significantly understated as only 30 per cent of all small businesses are incorporated, the overwhelming majority trading as sole traders and partnerships"[9] is also noted.

In its submission, the Civil Contractors Federation NSW (CCF) included the results of a survey of its members on some of the key issues facing the Inquiry. More than 90 per cent of respondents indicated that they had been affected by insolvency. The survey also revealed that 15 per cent of respondents reported that they had terminated staff as a result of insolvency of another party and 65 per cent indicated that the potential for insolvency had affected their employment strategies. Similarly and perhaps of even greater concern for the economy of NSW, was the fact that 71 per cent of the respondents reported that they had limited their investment in business development, equipment acquisition, staff skills and improvement and innovation, due to the impact and risk of insolvency.

The effects of insolvency and the spectre of potential insolvency were even further ranging than those figures might suggest. A majority (54 per cent) of respondents replied that they had increased their tender prices in order to manage the costs of insolvency while 17 per cent said that they did not tender on some contracts because of who the customer was and the likelihood of payment problems.

These figures are important to bear in mind when balancing any remedial proposal against the costs of payment practices.

When asked whether or not existing payment practices and protections for subcontractors were adequate, 88 per cent of CCF members who responded to the survey, reported that existing protections for subcontractors were inadequate to protect them from the impact of insolvency.

Questions/Issues for comment

- **No witness to the Inquiry thus far has convincingly advanced the idea that subcontractors are protected to a proper or appropriate level from the consequences of insolvency.**

- **The Inquiry is presently of the view that subcontractors are not adequately protected.**

[9] Submission, NSW Small Business Commissioner.

Terms of Reference: Paragraph 2 (i)

Consider payment practices affecting subcontractors

"Pay when paid" has been outlawed by SOPA (see s 12 of SOPA). In effect however, that continues to be the way the payment cycle is operated in the construction industry in NSW. Contractors' business is organised so that it is not until they have received a progress payment from the owner/principal that they in fact pay moneys due to a subcontractor included in the progress claim to the owner.

The result is that in a common[10] payment cycle in the construction industry, a contractor may be paid a progress payment by the owner/principal on or about the 10th day of the month and it will not be until the end of that particular month in which payment is received, that the contractor will pay the outstanding subcontractor's progress claim relating to work carried out by the subcontractor in the previous month. Assume that the subcontractor has worked for 28 days in the month in which he submits his progress claim and it can readily be seen that the result of a 28 day payment cycle calculated upon the basis that the subcontractor submits his progress claim at the end of the previous month, results in subcontractors not being paid for work carried out more than 50 days prior to the date of payment.

Some of the contractors in what may be called the top tiers of the industry have informed the Inquiry that they may on occasion make special arrangements to pay subcontractors earlier than the end of the month after the subcontractor's progress claim is submitted, if for example, the subcontractor's progress payment was highly labour intensive and, as is normally the case, the subcontractor pays its labourers' wages on a weekly basis.

A 28 day payment cycle from receipt of the subcontractor's claim seems to be reasonably common for the top tier contractors in the industry. For the top tier contractors the result is that in a payment cycle of the kind referred to above, there is a period of at least 18 days (generally more) during which the contractor has unrestricted use of the owner's earlier progress payment. This occurs in an industry about which a number of witnesses have said "success comes as a result of your ability to use other peoples money".

The utilisation of progress payments in that way is not illegal and is not in breach of the sub-contract so long as funds are available to meet the subcontractor's terms of payment, which in the example under discussion is 28 days. One witness to the Inquiry emphasised that the use by head contractors of money earmarked for subcontractors work is "an abuse, not a use of cash flow".

[10] At the favourable end of the scale, although the Inquiry heard evidence of widespread payment practices where the subcontractor waited 45 to 80 days.

There was also evidence to suggest 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. The Inquiry heard that one large interstate contractor has recently been informing prospective subcontractors that if they wish to work on its jobs then payment terms will be 90 days. This of course means that contractors have, in those cases, a considerably longer period in which to make use of the funds as they see fit before subcontractors are paid.

Of course one of the real effects of delayed payment is to add further pressure on the capacity of subcontractors to pay their debts and keep their enterprise afloat. This Inquiry is focussed on considering effective and practical options to better safeguard the interests of subcontractors.

Options to enact prompt payment provisions that ensure subcontractors do not face overly long periods without payment for work performed are discussed later in this Paper.

Questions/Issues for comment

- **Subcontractors have little option but to agree to payment terms such as those outlined above, in an industry where margins for both contractor and subcontractors are approaching if not settled, at an all-time low.**
- **The need to protect current work arrangements and not damage prospects of securing future work, means that many subcontractors simply take the work that is offered to them, at a price they may not agree to under different circumstances.**

There is no doubt that SOPA has brought about a significant improvement in the position of subcontractors. The veracity of this statement has been confirmed to this Inquiry time and time again through oral and written submissions. Data released by the NSW Department of Finance and Services for the financial year 2011/12 shows that:

- 1112 applications for adjudication were lodged;
- More than 77 per cent of claims were made by subcontractors and contractors;
- The total value of claims was in excess of $223m while the total value of adjudicated amounts was $77.9m; and
- Just under 50 per cent of adjudication certificates were for amounts under $25,000.

However the Inquiry has also heard evidence of one head contractor telling a prospective subcontractor that “if you’re going to put those words on your progress claims then you won’t get the work”. This was a reference to the requirement that subcontractors include a statement in each payment claim under section 13(2)(c) of SOPA, to the effect that the claim is being made under the Act.

The subcontracting sector is heavily dependent upon maintaining relationships and many subcontractors are reluctant to bring SOPA proceedings against a contractor who is still

regarded as a future source of return work. The attitude seems to be that the subcontractors prefer to "take the hit than bite the hand that feeds".

The most extravagant version of this stoic approach was the suggestion by one witness to the Inquiry that no formal steps should be taken in the case of a failure by a contractor to pay a subcontractor and the problem could easily be "sorted out in the local pub" by a less than anonymous denunciation of the delinquent contractor and its failure to pay. That is not an approach that commends itself to the Inquiry.

The use of statutory declarations which are customarily required to be provided by head contractors to the owner/principal advising the principal that relevant payments due to subcontractors have been paid, came under attention on a number of occasions. It was made clear to the Inquiry that in many cases these statutory declarations are false, signed in blank sometimes in a block, or are simply circumvented by the device of the contractor "renegotiating" the terms of payment with the subcontractor who has no choice but to agree, so that the money otherwise "due and payable" to the subcontractor only becomes "due and payable" at the later renegotiated date. The statutory declaration thus achieves a dubious credibility.

Terms of Reference: Paragraph 2 (ii)

Existing protections for subcontractors

In NSW existing protection to subcontractors includes:

i. SOPA;
ii. Some contractual 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);
iii. The option of going to arbitration if the contract so provides;
iv. The option of expert determination if the contract so provides;
v. The option of going to court;
vi. The *Contractors Debts Act 1997* (NSW); and
vii. The *Personal Property and Securities Act 2009* (Cth).

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 and rely almost exclusively upon regular cash payments, there is no buffer which they may place between themselves and a failure to pay, or a failure to pay upon time. All of these problems must be examined in the context of the much weaker bargaining strength of the subcontractor. The

context is more often than not, one of substantial bargaining inequality, to the detriment of subcontractors.

Questions/Issues for comment

- **There is a case that may be made that existing protections are inadequate and should be improved[11].**
- **It is noted that the NSW Government - GC21 (Edition 2) - General Conditions of Contract includes trust fund provisions. Do these provisions work and is there a case to be made for these provisions to be mandated in all construction contracts?**

Terms of Reference: Paragraph 2 (iii)

Impacts of insolvency on subcontractors

The Inquiry has heard many sad accounts of the impact of insolvency on subcontractors.

As part of its work, the Inquiry has examined a number of case studies in order to understand and evaluate the adverse family, business and personal effects of insolvency in the construction industry. These case studies will be included in the Inquiry's Final Report. One of them is reproduced in the appendices of this Paper to provide context.

The Inquiry has received more than 60 submissions to date, many from subcontractors who often describe in brief but precise detail, the massive impact that insolvency and the non-payment for work by contractors had on them personally, their family and of course their livelihood.

In addition to these submissions, members of the Inquiry's Industry Reference Group have referred a number of their members and others known to them, who have told the Inquiry of their experience of insolvency. The recurring issues and problems as told by subcontractors include:

- The withholding and non-payment of retention moneys;
- The 'manufacture' of a dispute by the head contractor about the work at the time the last progress payment becomes due;
- fear of losing future work and damaging relationships by utilising SOPA to recover moneys owed; and
- the ease and regularity with which builders become insolvent, with no funds left to pay debts owing to subcontractors.

[11] Several of which are not really regarded by subcontractors as "protections" at all.

The question so often asked is, why is it the case that those who do the construction work are paid last and are at greatest risk of not being paid?

Questions/Issues for comment

- **The Inquiry welcomes further evidence of the different impacts of insolvency on subcontractors.**

Terms of Reference: Paragraph 3 (a)

> ***Consider legislative or other policy responses that can be taken to minimise the incidence and impact of insolvency in the industry, including:***
>
> ***Options for improving the priority given to unsecured creditors where the debt results from a subcontracting relationship***

The Inquiry does not presently 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 an insolvency.[12] It welcomes submissions to the contrary. Such an amendment would require the co-operation of the Commonwealth. That is not a reason in itself for not recommending the proposal for further consideration. Indeed, there is every reason to think that the proposal would receive at least a sympathetic hearing from the Commonwealth.

The Inquiry is considering a number of other possible reforms for the purpose of protecting subcontractors. These reforms constitute a potential package which together with a better functioning SOPA, might be sufficient protection, rendering it unnecessary to go further to provide what in the Inquiry's view, would be an unjustifiable elevation of the subcontractor's position above the ruck of general creditors.

Nevertheless it seems to the Inquiry that as presently informed, the suggestion has a number of problems associated with it:

i) It is a band-aid solution at best. Insolvency history shows that elevation to a higher position in the rank of creditors is not likely to result in a significant enhancement of paid distribution.
ii) There are other prophylactic measures which are more suitable.
iii) Why give subcontractors a protection not available to others in the community who are also hit hard by insolvency and failure to pay debts owed to them.
iv) Subcontractors already have the benefit of SOPA.
v) A proposal of this kind does not attack the problem at its root cause.

[12] The Price Waterhouse Report of 1996 recommended such an amendment.

As is emphasised above, the Inquiry does not intend to recommend that subcontractors should receive additional protection under the Corporations Act against the general consequences of contractor insolvency.

Regrettably, consequences of that kind must continue to some extent, to be regarded and treated as unavoidable. Together with that approach must go the unremarkable conclusion that it is not possible for Government to protect those in business against all of the risks to which they might be subject, some of which are either created or increased by business owners' lack of attention to detail or financial mismanagement. It is neither desirable nor feasible to attempt to change the law to extend greater protection to subcontractors in the event of a contractor's insolvency beyond that which they would enjoy if some or all of the present options were implemented and brought into law.

The Inquiry has tentatively and provisionally drawn this conclusion in light of the following matters:

- SOPA affords subcontractors a considerable amount of protection not available to other groups in the business community.
- The operation of SOPA has in practice been of great benefit to subcontractors and while there is ample room to improve the operation of the Act and remove some of its anomalies, the universal view of those who spoke directly to the Inquiry was that the Act has been helpful to subcontractors and of course to contractors alike.
- Notwithstanding some of the unique characteristics of the construction industry, if, as floated as an option under the Terms of Reference, subcontractors were to be further protected by a construction trust which obliges the head contractor to hold money upon trust for the subcontractor, monies which have been paid to the contractor for work carried out by the subcontractor, then that is an additional benefit to subcontractors over and above the provisions of SOPA. Other sectors in the business and commercial community would be entitled to complain if further benefits were extended to subcontractors. Moreover, subcontractors should be encouraged by some of the different means mentioned in other sections of this Paper[13] to pay more regard to their interests and to tighten up their own approach to business management.
- If at some point, subcontractors were to receive legislative protections in relation to retention funds then an appropriate balance may have been struck. To go further may be unnecessary and to do so would be to place subcontractors in a special category in which they enjoy disproportionate protections not available to other groups in the community.

Questions/Issues for comment

[13] Particularly by utilising a broad based education program.

- **Are there particular reasons why subcontractors in the construction industry should be given greater priority in situations where they are an unsecured creditor?**

Terms of Reference: Paragraph 3 (b)

> ***Consider legislative or other policy responses that can be taken to minimise the incidence and impact of insolvency in the industry, including:***
> ***Opportunities to simplify debt collection processes***

The Inquiry notes that a review of the *Debt Recovery Process* commenced under the previous NSW Government in October 2010. The review was to examine the effectiveness and efficiency of the existing mechanisms and consider issues related to the cost and complexity of current processes, particularly court debt recovery processes and issues with enforcement of court judgments.

The Inquiry understands that this review has not yet been finalised.

In relation to claims for money made by subcontractors, there are four main categories:

i) Where the progress claim is not disputed;
ii) Where there is a dispute as to part only of the progress claim;
iii) Where there is a dispute as to the whole of the progress claim; and
iv) Where there is a dispute about retention fund moneys.

In these circumstances the key to the problem is to work out a means by which those monies not in dispute may be isolated and perhaps may be subject to an obligation to pay within a statutory period, upon a certificate, or, where the moneys are in dispute, the establishment of a Consumer Trader and Tenancy Tribunal (CTTT) mechanism which would bring about rapid adjudication.

Questions/Issues for comment

- **There is a lot to be said with doing away with the costly and inefficient Local Court, District Court and domestic arbitration proceedings for disputes say under $50,000 and for providing a means through a revamped CTTT for resolving such disputes quickly, fairly and efficiently.**
- **This may also be achieved through a legislative framework similar to that operating in Queensland (see Term of Reference 3(h) of this Paper) or through an integration and consolidation of existing functions within NSW Government departments and tribunals.**

Prompt Payment legislation

The Inquiry has received evidence indicating that the due date for progress payments for subcontractors can range anywhere from 18 to 80-90 days, with the average payment term falling somewhere between 45 to 60 days.

With this in mind, the Inquiry has been considering various ways of improving the regularity and speed of progress payments for subcontractors and in doing so has been reviewing the effectiveness of "prompt payment" legislation now operating in a number of Australian States and Territories, as well as those similarly in force in New Zealand, the UK and various States in the US.

At this stage, the Inquiry is considering whether some form of legislative amendment ought to be introduced to enhance the current provisions in SOPA dealing with the "due date" for progress payments. Specifically, the Inquiry is considering whether there should be some form of 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.

The Security of Payments legislation in Queensland, the Northern Territory and Western Australia already contain provisions which, to varying degrees, address this question. These are set out below.

Queensland:
Section 15 of the *Building and Construction Industry Payments Act 2004* (Qld) sets outs when the "due date" for a progress payment becomes payable in the following terms:

> **15 Due date for payment**
> (1) A progress payment under a construction contract becomes payable:
> (a) if the contract contains a provision about the matter that is not void under section 16 or **under the Queensland Building Services Authority Act 1991, section 67U or 67W**—on the day on which the payment becomes payable under the provision; or
> (b) if the contract does not contain a provision about the matter or contains a provision that is void under section 16 or **under the Queensland Building Services Authority Act 1991, section 67U or 67W**—10 business days after a payment claim for the progress payment is made under part 3.
>
> (2) Subject to subsection (3), interest for a construction contract is payable on the unpaid amount of a progress payment that has become payable at the greater of the following rates:
> (a) the rate prescribed under the Civil Proceedings Act 2011, section 59(3) for a money order debt;

(b) the rate specified under the contract.

(3) For a construction contract to which Queensland Building Services Authority Act 1991, section 67P applies because it is a building contract, interest is payable at the penalty rate under that section.

(**emphasis added**)

The critical aspect of this clause (which distinguishes it from its NSW counterpart (SOPA, s.11) is the reference to, section 67U and 67W of the *Queensland Building Services Authority Act 1991* (Qld) (**BSA**). Sections 67U and 67W provide:

Division 3 Construction management trade contracts and subcontracts

67U Void payment provision in construction management trade contract or subcontract

A provision in a construction management trade contract or subcontract is void to the extent it provides for payment of a progress payment by a contracting party to a contracted party later than 25 business days after submission of a payment claim.

Division 5 Commercial building contracts

67W Void payment provision in commercial building contract

A provision in a commercial building contract is void to the extent it provides for payment of a progress payment by a contracting party to a contracted party later than 15 business days after submission of a payment claim.

Northern Territory: In the Northern Territory, Part 2 (Division 1) of the *Construction Contracts Act 2004* (NT) sets out those provisions of construction contracts which are "prohibited". In this Part, s.13 relevantly provides:

13 Provisions requiring payment to be made after 50 days

A provision in a construction contract that purports to require a payment to be made more than 50 days after the payment is claimed must be read as being amended to require payment to be made within 28 days after it is claimed.

Western Australia: A similar "prohibited provision" section appears in Western Australia's *Construction Contracts Act 2004* (WA). In this Act, s.10 relevantly provides:

10 Prohibited: provisions requiring payment to be made after 50 days

A provision in a construction contract that purports to require a payment to be made more than 50 days after the payment is claimed is to be read as being amended to require the payment to be made within 50 days after it is claimed.

In addition to prohibiting "pay when paid" and "pay if paid" provisions in construction and/or building contracts, Queensland, Northern Territory and Western Australia have also legislated against contractual terms which may otherwise stipulate lengthy and unfair practices concerning the timing of payment of progress payments to contractors and subcontractors.

Considering the above, the Inquiry is inclined at this stage to seriously consider making a recommendation to amend SOPA so that it contains a provision modelled on either of the existing provisions outlined above, which deem void or prohibit those terms in construction contracts which purport to require payments to be made for unduly lengthy periods after a payment claim is made.

Questions/Issues for comment

- **Do you support the introduction of prompt payment provisions in SOPA?**
- **What might be an appropriate maximum time period for payment? You may wish to consider the existing provisions operating in some jurisdictions.**

  In Queensland:
  For construction management trade contractors and subcontracts: A provision which stipulates that a progress payment is to be paid more than 25 business days after submission of a payment claim is "void" (s.67U of the BSA).

  For commercial building contracts – A provision which stipulates that a progress payment is to be paid more than 15 business days after submission of a payment claim is "void" (s.67W of the BSA).

  In the Northern Territory:
  Provisions requiring payment greater than 50 days after being claimed are to be read as requiring payment within 28 days (s.13 of the *Construction Contracts Act 2004*).

  In Western Australia:
  Provisions requiring payment greater than 50 days after being claimed are to be read as requiring payment within 50 days (s.10 of the *Construction Contracts Act 2004*).

- **What form of evidence/certification should be required in relation to work performed and payment due?**

Terms of Reference: Paragraph 3 (c)

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

Strategies to improve financial management skills in the industry

It has been repeatedly observed by those who have come to the Inquiry to share their experiences, that particularly at the level of subcontracting operations in NSW, there is a pressing need for steps to be taken to improve the financial skills of those in the industry. At times these skills rise no higher than the requirements that subcontractors should regularly and in proper form ensure that their progress claims are made to the contractor. Quite often, subcontractors penalise themselves, particularly when they contend that they are due remuneration for variations, by not keeping proper records which in turn reflect upon the poor quality of progress claims and leads to disputes with the head contractor as to the amount due and payable.

The Inquiry has already firmly formed the view that subcontractors (and to a less extent contractors) need to develop a more acute awareness and understanding of tendering processes and a better appreciation and understanding of risk so that that risk can be properly priced and dealt with in the terms and conditions agreed upon. Education programs should offer analysis and comment upon the various forms of contract employed by head contractors, while accepting that in many cases the subcontractor does not stand upon an equal bargaining footing with the contractor.

At a lower level but nevertheless one which is of considerable importance, it is not clear at all that head contractors and subcontractors understand and apply a proper understanding to their Australian Tax Office obligations. Bookkeeping and accounting procedures in the conduct of subcontracting businesses vary in quality and the Inquiry suspects that as the subcontracting business demonstrates a smaller profile, so too does the bookkeeping, accounting and financial acumen fall below the desired standard.

Before spending any considerable time developing and completing a list of suggested means by which the business and financial management skills of the subcontracting sector might be improved, the Inquiry believes that it is worthwhile examining the existing resources within the Government structure and the existing resources available through industry and professional bodies which ought to be brought together in such a way to structure a collaborative effort to improve the business and financial and management skills in the industry. Whether this took the form of specially developed TAFE courses, on-line tuition and/or the preparation of manuals which would be made available free of charge to those in the business, are all matters that can be addressed by a composite group headed up by small business and industry and professional bodies.

An even better way to structure such an arrangement may be to bring it under the umbrella of a statutory authority such as is done in Queensland.[14]

Self help

It is the view of the Inquiry that in order to carry out its work in a balanced and sensible way, it is essential that the questions raised by the Terms of Reference also be considered from an overall viewpoint in which the opportunity for subcontractors' self-help is allowed to influence the Inquiry's reasoning.

In particular there are a number of steps which subcontractors may take, without necessarily causing any offence or damage to the relationship with contractors, which do not require legislative intervention and which are relatively cheap and simple to implement.

I refer in particular to:

- **The availability of trade credit insurance and the associated flow of information from the insurance company to the insured which can be of particular importance in putting subcontractors on notice of a financially stressed contractor which may not survive the course of the next project.**
- **The ability to have relatively cheap yet thorough financial checks and investigations carried out of the contractors for whom they contemplate working.**

The availability of measures of that kind should be emphasised in the education programme which is a part of the overall suite of recommendations likely to be made by the Inquiry. A knowledge and understanding of the availability of such self-help mechanisms is likely to engender a healthier and more efficient approach to business management on the part of the subcontracting sector. Although the matter is not specifically referred to in the Terms of Reference, the Inquiry is conscious of the fact that many hard working Australians in the subcontracting sector of the building and construction industry are people who do not use English as a first language, and who are not really comfortable being confined to any dialogue in English and certainly not in the case of business and financial affairs.

Performance Bonds

These bonds are available at the request of the owner and they are theoretically available from the head contractor at the request of the subcontractor. In the real world it is unlikely that the average subcontractor will be in a position to secure the head contractor's agreement to the establishment of a performance bond, however it is important that the availability of this product is pointed out to subcontractors. The subcontractor who wishes to be guaranteed payment, can upon payment of the necessary premiums ensure that it has the benefit of a

[14] For an examination of the position in Queensland and consideration of the different aspects of the Queensland licensing legislation see the terms of reference paragraph 3 (h) section of this Paper.

bond to secure the contractors obligation to make payment, or if it can secure the agreement of the contractor, stipulate that the contractor pay the premiums. These products are not as costly as many subcontractors would perhaps assume to be the case and it is important that they not be taken off the table in an inquiry of this nature.

The Inquiry contemplates that useful products of this kind should be given prominence as part of the education campaign referred to in other parts of this Paper and to be developed in further detail in the Inquiry's Final Report to be delivered to the Minister for Finance and Services on 14 November 2012.

The Inquiry notes that a range of material is currently available to small business operators to assist them in understanding and meeting a range of legal requirements in different industries. The Small Business Commissioner plays a vital role in this respect.

Questions/Issues for comment:

- **What might be some of the key elements of strategies to increase business financial management skills in the construction industry?**
- **Is there a need for mandatory continuing professional development for subcontractors in relation to business and financial skills**?

Terms of Reference: Paragraph 3 (d)

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

A mandatory insurance scheme to secure payments to subcontractors

To date, those who have communicated with the Inquiry have shown little interest in such a proposal. Increased costs in a tight environment no doubt contributes to that negative sentiment as would the paradox that if the subcontractor really needs that kind of cover if the contractor is in fact unhealthy, then the insurer will not write the insurance whereas if the good health of the contractor inclines the insurance company to offer cover to the subcontractor, then by hypothesis, the subcontractor does not need the cover.

Questions/Issues for comment:

- **Readers are again invited to comment upon the proposal.**

Terms of Reference: Paragraph 3 (e)

> ***Consider legislative or other policy responses that can be taken to minimise the incidence and impact of insolvency in the industry, including:***
>
> ***a discretionary mutual fund to compensate contractors from losses arising from insolvency of a lead contractor or principal***

There is little appetite for this proposal.

If there is in fact little present interest in such a proposal then it is important that this be flagged so that the Paper may present a time and opportunity for any in the community to comment in order to displace or to correct the impression this is not considered to be a matter of importance.

Terms of Reference: Paragraph 3 (f)

> 3. ***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 subcontractor payments retained by a lead contractor or principal***

Under this Term of Reference, the Inquiry is investigating the appropriateness and effectiveness of trust arrangements as a means of protecting, in the event of a head contractor's insolvency:

a) progress payments paid to the head contractor by the owner/principal including money due to the subcontractor ; and
b) subcontractor retention moneys retained by the head contractor.

In considering the issues arising in respect of the "trust arrangements" option and the framework for a possible statutory trust model in NSW, this section of the Paper will canvass the following matters:

1. The NSW approach thus far to the "trust" option, including the approach adopted in previous inquiries;
2. The types and elements of a valid construction trust;
3. The US and Canadian experience of statutory construction trusts;
4. The benefits and criticisms of the statutory construction trust proposal; and
5. The unexplored issues: The impact of a statutory construction trust upon the use of "free capital" and cash flow in the payment cycle; and
6. The special case of retention funds.

At this stage, the Inquiry has not formed any definitive views as to: (i) its recommendations concerning the "trust arrangement" proposal; and/or (ii) the exact framework and specific scope which any proposed trust model ought to take.

Rather, this Paper seeks to highlight various examples of construction trusts which are in operation around the world and to which the Inquiry is currently giving serious consideration. By doing so, the Inquiry hopes to facilitate further open debate as to the workability of these trust proposals.

For this reason, there are a series of questions specific to the statutory trust proposal at the end of this section to which the Inquiry invites you to respond.

The NSW approach thus far

Over the last 30 years or more, there has been considerable debate and much written about the construction trust.

So far as the investigation of the construction trust and its implications for those in the construction industry in NSW are concerned, there has not really been a clear construction trust proposal put forward along the lines of the now venerable mechanisms in the Canadian Provinces and in the American States, so that any proposed scheme may be looked at and critiqued in the light of its exposed detail. That said, the first thing that needs to happen is that any construction trust proposal should be spelt out with some particularity so that any criticism and comment upon it can be properly targeted and focused.

In the Cole Report it was said that whilst the Royal Commissioner, the Honourable TRH Cole QC, endorsed the legal effectiveness of the trust proposal,

> "…industry opposition to 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…"[15]

However as Mr Cole QC remarked, there was no detailed evidence given to support those criticisms.

Therefore, it is important that any criticism of the trust proposal in response to this section of the Paper is precise. It is not helpful to speak in general terms of the 'overbearing administrative weight' of such a proposal, or the 'uncertainty' of the proposal, or that it will 'add extra costs', without there being some specific evidence and reasoning to contribute to the debate to support those propositions.

The construction trust

[15] See the Cole Report at Volume 8 Chapter 14, p 250, paragraph 109

A diagram of a basic construction trust arrangement is provided in the appendices section of this Paper.

Types of construction trusts

From the vast collection of Canadian and American legal literature on the topic of construction trusts, the Inquiry notes that there are generally three types of trusts arising in the context of the construction industry:

> The statutory trust: As its name suggests this trust is a creature of statute. That is, the provisions of an act are drafted to deem, or automatically, create a trust in favour of the subcontractor in circumstances where the head contractor holds money for the benefit of the subcontractor.
>
> The express trust: This trust is contractual in nature and will typically arise through the express terms of the construction contract by agreement between the parties.
>
> The constructive trust: Unlike statutory or express trusts which arise via the language of legislation or contracts respectively, the constructive trust arises under the common law (at least as it is expressed in the United States) through the equitable doctrine of unjust enrichment. It is not a trust arising through any actual or presumed intention of the parties to create the trust but rather imposed purely as an equitable remedy.
>
> Constructive trusts are often imposed where a court has found that the party in possession of the property has wrongfully acquired the property (whether it be by fraud or otherwise) and it would therefore be against equity that that person should retain the "trust' property. In these circumstances, the person is deemed a "constructive trustee" and where a constructive trust is declared, the duties of the constructive trustee are limited and he is required to transfer the property to its rightful owner, account for any profits and may be required to pay any damages for the wrongful retention of the property.

The scope of this part of the Paper will focus on the "statutory trust" proposal; however, specific comments or criticisms which readers may wish to make concerning the express trust or constructive trust are equally welcomed.

Elements of the trust

In the case of a statutory construction trust and express trust, three requisite elements must be present for there to be a valid trust – namely:

1. Certainty of intent to create the trust - that is, a declaration or manifested intention of the settlor to create a trust;
2. Certainty of the subject matter of the trust – that is, certainty of the existence of, and a clear identification of the "trust res" or "trust property"; and

3. Certainty of the objects or beneficiaries of the trust – that is, a clear identification of the beneficiaries of the trust.

The Inquiry is of the view that certainty of intent, trust property and the intended beneficiaries could be made clear by an appropriate statute.

Take, for example, a typical US statute which provides that:

> "any money 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 or furnished materials, or both, for or about the building, for purposes of paying those subcontractors"[16].

Consider also the following contract trust provisions which are often used in the construction contracts of some American national and regional construction companies[17]:

From an owners standard condition of contract:

> **"9.7.3 Payments in Trust**
>
> Any funds that contractor receives in payment for services or Work performed by a Subcontractor shall constitute assets of a trust, which trust funds shall, … be used for the exclusive benefit of the Subcontractor for the purpose of discharging Contractor's financial obligations on account of labor, services, materials or equipment furnished to the Project by the Subcontractor, provided that such labor, services, materials or equipment were performed in accordance with the Contract Document, were included in an Application for Payment to the Owner, and were paid by the Owner to Contractor. Contractor shall be the trustee of the trust and shall be required to deal with the trust assets for the benefit of the Subcontractor. Contractor shall not be a beneficiary of the trust. Nothing herein shall be construed as an intent to require that Contractor maintain trust funds in separate bank accounts, specifically designate any third party as a beneficiary of the trust created herein, or otherwise give rise to any cause of action against the Owner by an third party beneficiary of the trust created herein."

From a general contractor's standard subcontract condition:

> **"Use of Payments by Subcontractor**

[16]Md. Code Ann. Real Prop., § 9-201(b)(1)

[17] Extracted from an article by Michael A Stoner Esq "Do you have trust issues? The Surety's Use of Trust fund, rights in Bankruptcy", Surety Claims Institute, June 2009

Subcontractor shall use the sums paid to it pursuant to this Subcontract solely for the purpose of fulfilling its responsibilities and obligations under this Subcontract. Any and all funds paid to Subcontractor hereunder constitute trust funds in the hands of Subcontractor to be applied before application to any other purpose to the payment of the following costs incurred by Subcontractor pursuant to this Subcontract:

(a) Sub-subcontractors, laborers, suppliers, material men or other persons employed by Subcontractor;
(b) Utilities furnished and taxes imposed;
(c) Premiums on surety bonds, other bonds and insurance required by the Attachments to this Subcontract;
(d) Any indemnity obligations of Subcontractors;
(e) Union or association dues, assessments and fringe benefits; and
(f) All other costs of Subcontractor's performance of its responsibilities and obligations under this Subcontract."

From a large regional specialty subcontractor's standard sub-subcontract agreement:

"5.4 Construction Contact Trust Fund

The parties agree and expressly declare that all funds payable to the Subcontractor under this Contract are trust funds, whether in possession of the Contractor or Subcontractor, for the benefit and payment of all persons to whom the Subcontractor incurs obligations in the performance of the Work. If the Contractor discharges any such obligation, it shall be entitled to assert the claim of such person to the trust funds. The Contractor, at its sole option, in implementation of the trust hereby created, may open an account, or accounts, with a bank or similar depository. Such account, or accounts, shall be trust accounts for the deposit of such trust funds and Contractor may deposit therein all monies earned by the Subcontractor pursuant to the Subcontract. Withdrawal from such accounts shall be by check or similar instrument signed by both parties. Said trust or trusts shall terminate on the payment of all obligations of the Subcontractor for the payment of which the trust or trusts are hereby created or upon the expiration of twenty years from the date hereof, whichever shall first occur."

Examples such as those outlined above would, *prima facie*, comply with all the necessary prerequisites for the establishment and constitution of the trust. However, some additional aspects would need to be made clear – for example, the legislation would need to stipulate whether the amount impressed with a trust includes payments which are in dispute.

One suggestion is that the amount of the trust money would need to be clearly defined by a certificate, specifying those amounts that are not in dispute and therefore able to be paid. If there is a dispute, then the disputed amount may be determined by the collateral dispute resolution system in NSW which, at that stage of the progress of the works, will be

constituted by SOPA[18]. Any non-disputed amount would remain in the trust fund together with the disputed amount until such time as the dispute is determined. That would prevent the undisputed amount from being paid out.

Whilst much turns on the terms of the trust, the Inquiry is interested in receiving comments on a trust model which:

(1) Limits the purpose of the trust to "payment of monies owed to subcontractors". The trust ambit would therefore be limited to payment out of the trust to those whom there is a direct contractual relationship and who fall within the terms of the model provisions set out above.

(2) Confines any protection to be afforded by the trust solely to progress payments owed by the contractor to subcontractor and in respect of which a payment claim has been made. That is, it will only protect the subcontractor in respect of the lost benefit of any progress payment which has been absorbed into the contractor's insolvency.

In looking at the above examples of possible construction trust models, it is timely to refer to the US and Canadian experience of trust arrangements.

The US and Canadian experience

Whilst it is beyond the scope of this Discussion Paper to provide a detailed treatise on the statutory construction trusts in America and Canada, it is nonetheless useful to share a little of the Inquiry's work to date about the experiences in these jurisdictions of the statutory construction trust.

The concept of the construction trust is not an original idea developed by the Inquiry. It may be traced back into legislation in many states in America and a number of Canadian Provinces.

In America, 16 of its 50 States have some enacted some form of construction trust fund legislation and in Canada the following Provinces have enacted statutory trust provisions (in its liens legislation[19]):

(1) Alberta: (AB) Builders' Lien Act R.S.A. 2000, c. B-7
(2) British Columbia: (BC) Builders' Lien Act S.B.C. 1997, c. 45
(3) Manitoba: (MB) The Builders' Liens Act R.S.M. 1987, c. B91
(4) New Brunswick: (NB) Mechanics' Lien Act R.S.N.B. 1973, c. M-6
(5) Nova Scotia: (NS) Builders' Lien Act R.S.N.S. 1989, c. 277
(6) Ontario: (ON) Construction Lien Act R.S.O. 1990, c. C.30

[18] Noting that after an adjudication there may still be further disputation and that SOPA is essentially "pay now, argue later".
[19] Whilst the statutory trust provisions are contained in the lien legislation, the various Acts and case law make clear that the trust remedy is separate and distinct from the lien remedy.

(7) Saskatchewan: (SK) The Builders' Lien Act S.S. 1984-85-86, c. B-7.1

The results of the Inquiry's research and discussion with various lawyers and administrators in America and in Canada (conducted by correspondence and by telephone conferences) have enabled the Chair to conclude that the construction trust has worked reasonably well on two fronts. Firstly, despite general assumptions, it has not imposed an undue administrative or cost burden upon the three major participants – being, the owner, the contractor and the subcontractor. Secondly, the decided cases in those American states and Canadian provinces where the construction trust has been legislated, demonstrate that the courts have not construed the trust provisions in a way which limits their effectiveness.

The Inquiry has reviewed the American and Canadian statutory trust provisions and sees much that can be drawn from the drafting of these provisions to assist in any model that may be developed in NSW. For example, the Inquiry is particularly interested in what is called the Contractors and Subcontractors Trust established under s.8 of Ontario's Construction Lien Act R.S.O. 1990, c. C.30. The Inquiry's interest in this system does not necessarily mean that it is the favoured or desired model to adopt.

A brief outline of the Ontario statutory construction trust is detailed below.

A Canadian Example - The statutory construction trust in Ontario:

In Ontario, Canada, the use of statutory construction trusts to safeguard payment for contractors and subcontractors alike is not a new idea and its implementation has gained acceptance and respect within the industry as another protective remedy for securing payment.

The statutory trust provisions set out in Part II, sections 1 to 13 of the Ontario ***Construction Lien Act R.S.O. 1990, c.30.*** The legislation creates a multi-tiered trust structure that establishes three types of statutory construction trusts as a requirement for receiving payments:

1. *Owner's Trust (section 7(1))*

   This trust entails that:
   - all amounts "received" by an owner that are to be used in the financing of the improvement;
   - all amounts payable pursuant to a certificate of payment; and
   - the earned and unpaid portion of the contract price following substantial completion,

   constitute a trust fund for the benefit of the contractor and prohibit the owner from using the trust money "for the owner's own use or any use inconsistent with the trust".

   In essence, the trust captures all monies of whatever kind which come into the owners' hands at any time from any source including rents.

   However, it is noted that this may be considered a radical remedy for the current climate in

the NSW construction industry and is hence not under consideration as part of the recommendations contemplated by the Inquiry.

2. *Contractor's and Subcontractor's Trust (section 8(1))*

This trust requires that all amounts:

- owing to a contractor or subcontractor (whether or not due and payable); and
- received by a contractor or subcontractor on account of the contract or subcontract price of an improvement,

constitutes a trust fund for the benefit of the subcontractors and others who have supplied services or materials and are owed amounts by the contractor or subcontractor. One of the limiting **characteristics** of this trust is that the beneficiary must have privity of contract with the trustee. This is not a misuse of equity and common law terms - it is simply a statement of the requirement that the trust should arise as between people who are in an earlier relationship of privity by means of the contract between them.

As in the *Owner's Trust*, the contractor or the subcontractor (as circumstance determines) is prohibited from using the trust money for its own use or in a manner inconsistent with the trust until the beneficiaries have been paid first.

3. *Vendor's Trust (section 9(1))*

Lastly, there is the Vendor's Trust which stipulates that where the owner's interest in premises is sold by the owner, an amount equal to:

- the value of the consideration received by the owner as a result of the sale, less the reasonable expenses arising from the sale and the amount, if any, paid by the vendor to discharge an existing mortgage indebtedness on the premises,

constitutes a trust fund for the benefit of the contractor.

Under this type of statutory trust where a project has been completed and the contractor has not been paid, the money that the owner makes on the sale of the property is subject to a trust fund and for the payment of any outstanding debts to the contractor. The Inquiry does not favour a trust of this kind. Comments are welcome.

<u>Breach of the Trusts</u>

Over the years that the statutory trust system has been implemented, a substantial body of case law has provided numerous examples of what could be considered a breach under the legislation. A breach of trust can include any use of trust funds:

"

- from one project to pay accounts arising from another project or otherwise unrelated to the improvement;
- to pay for overhead costs, such as rent, head office personnel, payroll, or bank charges;
- to repay loans (unless the borrower can prove that the very debt repaid was advanced and actually applied to legitimate trust purposes); and
- in a manner that sees those trust funds commingling with other funds in an operating

bank account."[20]

Defences available for breach of trust

The trustees specific defences to breaching the trust include:

- payments discharging trust (section 10);
- reducing trust finds where other non-trust amounts have been used (section 11(1));
- application of trust funds to discharge loans (section 11(2)); and
- set off by the trustee for amounts that may be owed by the beneficiary (section 12).

Personal Liability for Statutory Trust Breaches

Under the Ontario legislation, personal liability for a breach of a statutory trust applies to "*the directors, officers, employees, agents, and anyone who has 'effective control' of the corporation or its relevant activities*".[21] This liability also attaches even where the conduct attracting liability is assented or acquiesced to by those that knew or ought to have known amounted to a breach.

It is also noted that in certain circumstances a director or officer facing personal liability may not escape liability by claiming bankruptcy given that section 178(1)(d) of the *Bankruptcy and Insolvency Act* R.S.C. 1985 c.B-3 specifies that an order of discharge under this Act does not release a bankrupt from "any debt or liability arising out of fraud, embezzlement, misappropriation or defalcation while acting in a fiduciary capacity"[22]; which includes breaches of trust. However, whether this is a system that could be implemented in NSW is still under consideration by the Inquiry.

Questions/Issues for comment

- **As indicated above, the Inquiry is giving special consideration to whether a statutory trust provision, modelled along the lines of the statutory trust provision in s.8 of the Ontario's Construction Lien Act R.S.O. 1990, c. C.30, should be adopted. It is to that specific provision that the Inquiry invites responses.**

- **The Inquiry would like to receive detailed and reasoned comments on the benefits and the problems that would be associated with establishing and implementing a legislated trust fund system in NSW and detail the impact it may have on the construction industry.**

- **Readers are asked to comment upon some specific questions about the Construction Trust itself set out at the end of this section.**

Benefits and Criticisms of the construction trust proposal

[20] Page 3 "*Construction Trusts in Ontario*", Charles G.T Wiebe and Duncan W. Glaholt, 2003
[21] Page 6 "*Construction Trusts in Ontario*", Charles G.T Wiebe and Duncan W. Glaholt, 2003
[22] Page 7 "*Construction Trusts in Ontario*", Charles G.T Wiebe and Duncan W. Glaholt, 2003

In making any recommendation about the trust option, it is the Inquiry's function to highlight and put before Government both the stated benefits and criticisms expressed by the industry and community.

Benefits

The likely benefits of implementing the statutory construction trust include:

a. The protection against insolvency or bankruptcy in respect of progress payments made by the owner to a contractor where a significant amount of that progress payment includes moneys owed to the subcontractors.

b. An improvement in the reliability and regularity of payments to subcontractors.

Criticisms

The Inquiry is also aware of the criticisms of the statutory construction trust that appear in a variety of different sources and those to which express reference are made include:

- The Cole Royal Commission into the Building and Construction Industry;[23]
- The Andersen Consulting Feasibility Report prepared for the Department of Industrial Relations, Employment, Training & Future Education, May 1993;
- The Price Waterhouse Report prepared for National Public Works Council Inc. titled *Improving Security of Payment in the Building and Construction Industry*, 19 July 1996;
- An article by Jane Jenkins titled "The Latham report trust fund proposals" published in the Construction Law Journal (citation: (1995) 11 CLJ 262-273);
- Submissions received and included in the *Report of the Joint Standing Committee upon Small Business entitled "Security of Payment, Deemed Trusts: The Full Debate"*, August 1998;
- Others who have written into the New South Wales Government and made various submissions of one kind or another including the NSW Government's 2010 review of the *Building and Construction Industry Security of Payment Act 1999* and *Contractors Debts Act 1997*; and
- Those who came to place material before this Inquiry.

The Inquiry notes that while not looking specifically at trust fund arrangements, the Report of the Gyles Royal Commission into Productivity in the Building Industry in New South Wales made comments on issues relating to insolvency in the construction industry.[24]

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'.

[23]See Volume 8 (Reform – National Issues Part 2): Chapter 14 – "Security of Payment", paras [102] to [109]
[24]Final Report (Volume 7) in Chapter 15 entitled "Insolvency

So, it is suggested for that reason that if the Inquiry were to recommend the creation of a statutory construction trust then it would be doing a disservice to subcontractors. The Inquiry is of the view that this point is unmeritorious.

Trading while insolvent

While the Inquiry did not have specific evidence upon which such a conclusion could be based it must be stated that a significant number of witnesses, with broad and deep experience in the construction industry and the insolvency profession, expressed the view that almost certainly there were a significant number of companies in the construction industry trading whilst insolvent.

Great care must be taken in the utilisation of such a conclusion and one should not place too much reliance upon it. However what it does do in the mind of the Inquiry is to renew emphasis upon the desirability of enforcing present laws concerning insolvent companies trading.

If those laws were enforced a little more ardently than they have been to date, then there would be a consequential alleviation of the consequences of such insolvency of such companies upon subcontractors.

The Inquiry of course recognises that it is sometimes extremely difficult in the construction context for a financial analysis to determine whether or not a contracting company is trading while insolvent. One of the principal reasons for this difficulty is the commonplace occurrence where the contracting company includes in its balance sheets the value of claims which it contends are sound and will result in substantial payments to it in the future. Those minded to prosecute the director(s) of such a company for insolvent trading face the difficulties of having to disprove the often highly technical and complex claims made by the contract company in relation to its cash flow situation.

All of that said, any analysis of the problem of insolvency in the construction industry should not necessarily do so exclusively from the point of introducing zealous law reform, but also spoken from the view point of the revisiting and enforcing the availability of existing legal protection.

The unexplored issues

The Contractors use of "Free Capital" within the Payment Cycle

The next step in the analysis of the trust scheme is of great importance and has not been the subject of much earlier attention. This question concerns the way in which the proceeds of a progress payment made by an owner to a lead contractor are applied.

The CEO from one highly respected building company told the Inquiry:

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

To illustrate this issue, the following example is provided.

Consider a construction project in which the terms of payment between the head contractor and the subcontractor is 28 days[25]. Then, in any given month the payment cycle consists of a progress payment by the owner/principal to the head contractor on the 10th day of the month. That progress payment will include a considerable amount of work done and materials supplied by the subcontractor in the earlier month and claimed by the subcontractor against the head contractor in a progress claim forwarded at the end of the last month – that is, 10 days before the progress payment is made by the head contractor and received by the owner/principal. The narrative is completed when the head contractor pays the subcontractor on the 28th day of the same month.

CONTRACTOR/SUBCONTRACTOR MONTHLY PAYMENT CYCLE

In the example outlined above, the payment terms allow an 18 day gap in the payment cycle between head contractor and subcontractor. This means that for at least 18 days, the head contractor has the "free use" of those funds and 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.

Progress payments of this kind are recognised by all three main players in the contractual payment chain - the owner/principal, head contractor and the subcontractor - as containing funds that are often ultimately destined and due to be paid to the subcontractor. However, in the case example outlined above there is no legal impediment to such an investment taking place (or "treasury function" as it is known) as the present state of the law on the state of these moneys at subject is clear – such funds are <u>not trust funds, and will not be deemed to be, unless:</u>

[25] This would be a case of good payment behaviour. The evidence before the Inquiry as to payment cycles is at variance. The gap in the payment cycle between the head contractor payment and the contractors payment to the subcontractor varies from 18 to 90 days.

a. by agreement between the parties that the trust has been specifically constituted; or
b. a trust is created by virtue of legislative provisions similar to those in America and Canada.

The Inquiry has questioned a number of contractors and other interested parties including accounting and insolvency professionals, 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:

a. The funds may be retained in a bank account on commercial rates of interest (for say the 18 days) with the proceeds of the investment retained by the head contractor.
b. 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 a short term money market or invested with another non-bank financial and debentures at call.
c. 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.
d. The funds may be let out at relatively high rates on secured investments.
e. The funds may be let out on unsecure investment.
f. The funds may be used to pay debts of the head contractor on the particular job at hand.
g. The funds may be used to pay off other debts of the head contractor.
h. The funds may be used to help finance other jobs of the head contractor; and
i. The funds may be spent on discretionary luxury spending or unrelated personal purposes outside the contractor business profile eg: holiday homes, boats or development ventures in which the contractor is engaged collaterally at the same time as its commercial construction work for an owner client.

It must be immediately noted that there is nothing unlawful or unethical about each of the "investment" practices outlined above in the absence of more information. 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 (say the 28th day of the month) 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 (i) 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".

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 canvased in any detail and surprisingly, was not brought to the forefront of discussions or submissions in the present Inquiry until the Inquiry began to focus particular attention upon it.

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 there 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.**

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.**

Cash flow

In an often quoted passage, Lord Denning made the following observations about "cash flow" in 1973:

> "When the main contractor has received sums due to the subcontractor - as certified or contained in the architect's certificate – the main contractor must pay those sums to the sub-contractor. He cannot hold them up so as to satisfy his cross-claim. Those must be dealt with separately in appropriate proceedings for the purpose. This is in accord with the needs of business. **There must be a 'cash flow' in the building trade. It is the very lifeblood of the enterprise (emphasis added)**. The sub-contractor has to expend 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. The main contractor is in like position. He has to pay his men and buy his materials. He has to pay the sub-contractors. He has to have cash from the employers; otherwise he will not be able to carry on. So once the architect gives his certificates, they must be honoured all down the line. The employer must pay the main contractor; the main contractor must pay the sub-contractor and so forth."[26].

Cash flow may be "the very lifeblood" of the construction industry, but can such an expression be treated as absolute without considering the position of those whose work has substantially given rise to the head contractor's entitlement to be paid?

Conscious of such issues, the Inquiry is considering whether it is feasible to create a statutory construction trust along the lines of the above models, while at the same time authorising the statutory trustee (that is, the head contractor), to invest what has become trust moneys, in investments akin to those types of investments set out in the Guidelines for Trustees under clause 4 of the Trustee Regulations 2010. An extract of clause 4 of the Trustee Regulation 2010 is included in the appendices section of this Paper.

Absent such an ameliorating provision the head contractor would not be authorised to "invest" what are impressed trust funds or to make a profit for itself. It would certainly not be entitled to retain the profits made upon the investment of the trust fund. A related question is whether or not and the extent to which it is meaningful, to speak about the opportunity to invest if a very prompt payment cycle was mandated.

Once funds have been initially impressed as "trust funds" then those funds, provided they are traceable, remain impressed with the same trust status throughout the course of dealings with them and under the above model, would remain clearly recognisable as trust funds in the form of the invested fund.

For example, if a payment made by an owner to a head contractor included a large amount of money for a subcontractor's work, then from the moment those funds became impressed with

[26] *Modern Engineers (Bristol) Ltd v Gilbert Ash (Northern) Ltd* (1973) 71 LGR 162 at 167.

that trust, they would remain impressed with the same trust even when invested in other forms of investments such as those provided for under the NSW *Trustee Act 1925* and listed in clause 4 of the Trustee Regulation 2010. Here, the subcontractor would retain the same protection in relation to that altered investment fund as they did relation to the first fund.

If this suggested investment proposal was implemented it might be linked to a provision which also entitled the contractor to retain any profit made on investment of the fund within the legitimate payment cycle - that is, for the period leading up to the day upon which the subcontractor must be paid. That would be a radical departure from the existing law which forbids a trustee from profiting from the trust.

Contractors are invited to examine the list of investments set out in clause 4 of the Trustee Regulation 2010. Leaving to one side that the value of the trust funds to which these guidelines apply has been capped at $50,000, if restrictions were imposed to limit investments to the type specified in that list, the Inquiry is interested to hear whether this would have any effect upon contractors company operations. For example, in circumstances where the rates of return on offer from the investments in the Guidelines for Trustees falls short of those which the contractor has been historically, or currently enjoying.

For the reasons discussed above there can be no doubt that a trust arrangement if properly implemented, would protect the subcontractor in the case of a head contractor's insolvency, against the application of a progress payment already made to the contractor, the whole or part of which related to work carried out by the subcontractor.

Retention Funds

On the moral scale of things it is difficult to resist the immediate conclusion that when it comes to retention funds, reform is necessary. Not one witness to the Inquiry was able to muster any cogent argument against the idea that retention funds should be held as a genuine trust fund and such monies placed in a separate bank account with two joint signatories – being, the contractor and the subcontractor.

In the case of retention funds, the area of reform is clearly suggested by the way in which retention sums are accumulated by the head contractor from progress payments due and owing to the subcontractor. 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, the necessity for the subcontractor to make good on defective work or materials.

The standard form contracts

Some standard forms of contracts contains 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 contractor is entitled to receive them.

For example, in NSW's "GC21 (Editions 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.

Consider also "AS2124-1992- General Conditions of Contract" in which clause 5.9 proffers 2 alternative clauses:

> **Clause 5.9 Interest on Security and Retention Moneys**
>
> *Alternative 1*
> A party holding retention moneys and/or cash security shall forthwith deposit the moneys in an interest bearing account in a bank. That party shall nominate the bank and the type of account. The account shall be in the joint names of the Principal and the Contractor and shall be one from which moneys can only be drawn with the signatures of two persons, one appointed by each of the Principal and the Contractor. The moneys shall be held until the Principal or the Contractor is entitled to receive them.
>
> Interest earned on security lodged by the Contractor and on retention moneys belongs to the Contractor. Interest earned on security lodged by the Principal belongs to the Principal. Upon the Principal or the Contractor becoming entitled to receive any moneys, including interest in the account, the other party shall forthwith have that

party's appointee sign all documentation necessary to withdraw the moneys and shall give the signed documentation to the other party.

Alternative 2

A party holding retention monies or cash security shall own any interest earned on retention monies or security. Except where retention moneys or cash security are held by a government department or agency or a municipal, public or statutory authority, retention moneys or cash security shall be held in trust by the party holding them for the other party until the Principal or the Contractor is entitled to receive them.

Common sense dictates that retention funds accumulated in this way should be deposited into and remain in a clearly entitled separate trust account to which the contractor and the subcontractor are joint signatories. As has been said above, this has received almost universal support.

The shortcomings of standard form contract clauses which afford retention moneys "trust status" lie in the fact that they are not mandatory for inclusion in all construction contracts and therefore do not universally govern the use of these funds in all contractual relationships in the construction industry.

One way to overcome this is by way of legislative reform.

Legislative reform

The Inquiry notes that Western Australia has taken this legislative step and enacted in its Security of Payments legislation, a statutory provision regulating the status of money retained by the principal for the performance by the contractor of its obligations.

Clause 11 of Schedule 1 (Division 9) of the *Construction Contracts Act 2004* (WA) provides:

Division 9 — Retention money

11. Retention money to be held on trust

If the principal retains from an amount payable by the principal to the contractor for the performance by the contractor of its obligations a portion of that amount (the ***retention money***), the principal holds the retention money on trust for the contractor until whichever of the following happens first —

(a) the money is paid to the contractor;

(b) the contractor, in writing, agrees to give up any claim to the money;

(c) the money ceases to be payable to the contractor by virtue of the operation of this contract; or

(d) an adjudicator, arbitrator, or other person, or a court, tribunal or other body, determines that the money ceases to be payable to the contractor.

Such a provision affords protection to the contractor's retention moneys in the event of the principal's insolvency. The Inquiry sees logic in extending a legislative provision of this nature so that it could equally apply in the head contractor/subcontractor relationship.

As is the case with all suggested legislative reform, the question of unintended or undesirable consequences must be examined. For example, if there was push back by head contractors against a proposal of this kind which might have the unintended consequence of placing pressure upon subcontractors to provide a bank guarantee in circumstances where those at the low end of the subcontracting market are simply unable to do so.

If retention moneys are genuinely trust funds, a matter over which doubt should be removed by imposing a statutory trust over such funds, then those builders who work to a sound and conscientious rule would not be minded to place undue pressures and demands on subcontractors to enter into a bank guarantee.

Some questions about the Construction Trust itself

1) **What are the terms of the trust? It is suggested that the trust may follow the lines of the model section reproduced above. In order to come to a concluded view about that, one must first analyse whether or not the three separate trusts which are brought into existence by the Ontario legislation is the model that ought to be followed [27].**

2) **What is the trust property? How is it to be specifically ascertained if there is a dispute between the contractor and the subcontractor as to the proper amount of money said to be due and payable by the head contractor to the subcontractor?**

3) **For how long is the head contractor entitled to hold the trust monies?**

4) **What are the duties of the head contractor as trustee?**

5) **How does the proposal work for multiple subcontractors and suppliers flowing down the construction line?**

6) **Is the trust an effective protection for the subcontractor in the event of the contractor's insolvency? If so, to what extent?**

7) **How can the subcontractor, as beneficiary under the trust, be protected against the consequences of unauthorised payment out of the bank account in which the trust funds are being deposited?**

8) **If the owner makes one payment in satisfaction of a progress claim by the head contractor which includes monies due to the contractor and the subcontractor what is the appropriate mechanism by which the head contractor is properly paid?**

[27] See paragraph on page 35

9) **How can one determine what is owing to the subcontractor in the progress claim forwarded by the head contractor to the owner?**

10) **Are there any significant tasks or additional costs associated with the construction trust procedure? For example should those funds be placed in a separate trust account and**

11) **What, if any, is involved for the owner in this process.**

12) **What is to happen if there are insufficient funds in the trust account to pay all of the subcontractors? For example, can the head contractor decide, at its discretion, which subcontractors to pay in the event of a shortfall?**

Project Bank Accounts

The Project Bank Account, otherwise known as the "PBA", is a relatively new concept and has been developed and enthusiastically promoted exclusively in Government projects in the United Kingdom (UK).

Indeed, as part of its fair payment charter, the UK Office of Government Commerce commended the use of PBAs by public sector clients "where practical and cost effective".

What is a PBA?

A neat summary of what a PBA is and how it works appears in a guide recently published by the UK Cabinet Office titled "*A Guide to the implementation of Project Bank Accounts (PBAs) in construction for government*" (**UK Cabinet Guide**). On page three of the UK Cabinet Guide it states:

> ***"What is a PBA and how it works***
> *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."*[28]

[28] UK Cabinet Office. "A Guide to the implementation of Project Bank Accounts (PBAs) in construction for government", page 3.

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.

A complete copy of the UK Cabinet Guide, together with a suite of other useful documents published on the topic of PBAs is available on the Inquiry's website (accessible at http://haveyoursay.nsw.gov.au/construction-industry-inquiry).

The Inquiry's work so far in understanding the PBA

The Inquiry has spent some time investigating the PBA system in an endeavour to ascertain whether it would work as a practical, cost effective and efficient means of improving the 'supply-chain' payment processes within the construction industry in NSW.

To date, the Inquiry has undertaken research as to the reasons the PBA was introduced and how it operates and has also spoken with representatives of the UK Cabinet Office, London banks and international property and construction consultants and practitioners who have had some experience in both developing and using this payment process mechanism.

This Paper does not purport to set out, in chapter and verse, the background details, intricacies and requirements surrounding the operation and implementation of PBAs. The materials made available on the Inquiry's website have been collated specifically for this purpose, and, are adequate to do so.

What this Paper does seek to do though, is facilitate further discussion from the industry and community by highlighting some of the perceived benefits and criticisms which have been made of this payment system. Therefore, in considering what follows, the Inquiry strongly urges all readers and interested parties to thoroughly review the PBA documents made available on the website and where necessary, factor that information into any comments provided in response to this Paper on this topic.

The Benefits of the PBA

Discussions with the UK Cabinet Office and longstanding quantity surveying firm, Rider Hunt Bucknall (whose London office was appointed as specialist advisers to the UK Office of Government Commerce in the development of their "Guide to Best Fair Payment Practices" and the related PBA), demonstrate that there is considerable optimism both as to the past, present and likely future success of PBAs as a means of improving the payment process for all in the construction chain.

Nevertheless, the Inquiry has endeavoured to draw from the community whether there are any criticisms of that system and the Inquiry spent some time considering submissions which were highly critical of the PBA arrangement.

It has been suggested that the PBAs involve more administrative and clerical work. That is probably right although the Inquiry does not think that the additional work is significant in the light of the advantage to be won by the application of the system.

In the United Kingdom it has been suggested and there are financial studies to support this conclusion, that the implementation of PBAs is reducing the costs the overall costs of Government work in the UK by somewhere in the order of 1.5 – 2.5 per cent and it is hoped that those savings might be improved.

Details of PBAs as they are operated through Barclays Bank and the Royal Bank of Scotland in the United Kingdom, have also been posted to the Inquiry's website and may be accessed at http://haveyoursay.nsw.gov.au/construction-industry-inquiry

For that reason the Paper will serve an important purpose if it outlines the suggested benefits of the implementation of a PBA Scheme together with a summary of criticisms that have been made of this scheme.

In the United Kingdom the Cabinet Office has prescribed minimum standards for PBAs in a document entitled "PBA Guide published July 2012" and the Inquiry has posted that document on its website.

The claimed benefits of the PBA system

The UK Cabinet office in London developed a benefits methodology in line with the Treasury Department standard approach to calculating the predicted savings in using fair payments and PBAs. A supply chain survey was conducted together with a follow-up supply chain survey, further surveys and workshops. This work was supplemented by an analysis of the top ten main contractors in the United Kingdom in order to determine the impact of reduced debtor days on profit margins and cash flow.

The Inquiry emphasises that the amount of work of an investigative nature carried out in the United Kingdom in relation to the PBA system, has been substantial and there is a sound basis for placing confidence in the conclusions drawn in the United Kingdom. It is not readily apparent that there is any material or significant distinction between the UK industry set up which might suggest that the United Kingdom conclusions are not appropriate in the NSW context.

Criticisms of the PBA

With that in mind it is important to reproduce some of the criticism of the PBA system which the Inquiry invited from those who wish to express an opinion upon that subject.

In its written submission to the Inquiry, one large national building company expressed the view that:

> "…… Project Bank Accounts are not appropriate for the Australian market and do not resolve issues where a project has been under bid, for example on a negative margin."

The essential premise of the submission is that it was imperative that cash is not kept out of the contractor's business. The submission correctly identifies the importance of parallel dispute resolution systems so that the money to be dealt with through the mechanism of a Project Trust Account could be confidently dealt with without a dispute. It is never going to be possible to prevent disputation between contractors and subcontractors but what can be done using existing methods is to ensure that either by certification, expert determination or some other collateral method, as much of the amounts which are not in dispute are put through the PBA system as is possible. The PBA system will neither add to disputation nor make it more difficult to clearly identify funds which are and which are not in dispute.

The submission goes on to state that in their experience PBAs are onerous, constitute administrative burdens and are costly to all parties involved. Concerns were also raised that the introduction of PBA's could lead to increased supplier failure risks, deterioration in contractors' ability to manage the supply chain, reduction in competition in the industry and reduction in investment in the industry. Widespread adoption of PBAs, it is claimed, would also have a significant impact on the free cash flow of contractors, damaging their general competitiveness.

Submissions critical of PBAs did not model any of the important criticisms made, however the Inquiry regards those criticisms as extremely important matters for future analysis and suggest that some attempt be made to model the criticisms along the lines of the pro-PBA modelling information available in the United Kingdom.

The Inquiry has sought the consent of the company making the above comments to refer its criticisms of the PBA system back to the proponents of that system in UK Cabinet Office in London and has invited a detailed response which will in turn be forwarded to each of those organisations which have made submissions to the Inquiry critical of the PBA system.

Owner's Escrow

The concept of the owner escrow recognises and should operate to counter balance to a degree, one of the risks faced by the owner as well as the head contractor namely, the risk of the *subcontractor insolvency*. An owner escrow operates by the owner putting funds in the escrow account to pay the contractor and the subcontractors. After the paperwork has been received and approved the owner ***then*** places the funds in the escrow account sufficient to draw cheques for the amount owing to the contractor and the subcontractor. Cheques are then drawn by the escrow agent and paid out to the contractor and the subcontractor.

Terms of Reference: Paragraph 3 (g)

> ***Consider legislative or other policy responses that can be taken to minimise the incidence and impact of insolvency in the industry, including:***
>
> ***mechanisms to ensure appropriate and effective financial disclosure between contracting parties, including disclosing payment of subcontractors***

For the reasons set out earlier in this paper, the question of "effective financial disclosure" cannot be looked at in isolation and the question of conducting a diligence analysis of a party's contracting partner, should not be confined to the investigation by an owner/principal of the financial management competence of a head contractor. Disclosure one would have thought, should come from the top down from the owner to the head contractor and then from the contractor down to the subcontractor and it should work up the chain of contractual relationships as well.

The Inquiry is all together well aware that there are limits to the extent to which in the real world, a subcontractor will go about investigating the details both financial and management of the contractor. The reality of that part of the industry is that the subcontractor is only too happy to be given the chance to carry out the work, particularly in present economic circumstances, and it is a forlorn hope to expect that subcontractors will conduct formal inquiries into the business and affairs of head contractors. Nevertheless the purpose of this Inquiry is not to offer a range of solutions to guard against the poor business judgements of subcontractors generally. There is a line beyond which Government cannot go in order to protect people against the consequences of their own carelessness. That line will be drawn differently according to a balance of all of the policy considerations one of which will be that in general terms subcontractors do not find themselves in a strong bargaining position.

However subcontractors ought not be relieved of the obligation to properly educate themselves in business and financial matters, to develop good financial management practices and to be reminded that it is not possible for them more than any other sections of the community, to be completely protected against all uncertainties nor their own foolishness.

What then can the subcontractors do in order to run the slide rule over the contractor before the subcontractor enters into a contract which might ultimately prove to be a disaster for it?

The subcontractors grapevine is of course a valuable source of information but that has not always been proved to have availed subcontractors in the past. It ought to be possible to predicate a level of inquiry that any subcontractor should be able to carry out. This may take the form of a routine inquiry through a company such as Dun and Bradstreet. The Inquiry notes that a one off payment risk report costs $61.50 while a more comprehensive report that provides advice on the risk that the company will encounter financial distress is available for $363.

These are not substantial costs, particularly considering the impact and cost of contractor insolvency on a subcontractor is considered. Of course there are other alternatives available.

As stated in an earlier section of this Paper, the Inquiry heard evidence from one subcontracting firm to the effect that it was unable through one of the larger insurance companies in Australia to obtain trade credit insurance in respect of a project it was contemplating entering into with St Hilliers. It seemed that the insurance company may have known considerably more about the difficult financial position of St Hilliers than did certain government departments. The Inquiry notes that expressions of interest for the tender to complete work on the projects left unfinished by the collapse of Perle Pty Ltd, closed on 29 November 2011. This work was awarded to St Hilliers on 9 March 2012. The company announced that it had gone into voluntary administration on 16 May 2012.

Part of the education process ought to be to heighten the awareness on the part of subcontractors that it is their primary obligation to make whatever necessary inquiries they think fit about the nature and character and business acumen and financial strength of any contractor who they are proposing to contract.

The Contractor's statutory declaration

A subset of this particular term of reference is the statutory declaration. The evidence of statutory declarations thus far given to the Inquiry reveals an initially unsatisfactory position. The statutory declaration process, one which was designed to ensure that an owner could confidently pay a contractor progress payment knowing that those payments due and owing to the subcontractors had been paid, is under constant abuse. That abuse takes a number of forms.

The Inquiry heard evidence that there were statutory declarations which were signed in blank sometimes in a block. Other statutory declarations were signed knowing them to be false but what appears to have been an increasingly common practice is that the statutory declaration is signed in accordance with its terms which require a statement that moneys "due and payable" to the subcontractor have been paid, to be read in the light of amended terms of payment which insure that the subcontractor is not owed money. In other words they are not due and payable because the time for payment has been pushed out. That result is obtained by an exercise of unequal bargaining power and in circumstances where the subcontractor agrees to that outcome it has little or no alternative but to do so.

Terms of Reference: Paragraph 3 (h)

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

> ***Other relevant issues or innovations raised by the Small Business Commissioner or stakeholders***

A NSW Retail Security Bonds type scheme

The NSW Small Business Commissioner has proposed that consideration be given to establishing an independent system whereby progress payment retention monies are deposited into a central account similar to the NSW Retail Security Bonds Scheme. This account would be administered by the dispute resolution unit of the Office of the Small Business Commissioner (OSBC) currently responsible for administering the retail scheme thus levering off its resources and existing corporate knowledge.[29] It is then proposed that in the same way that the security bond scheme operates, the cost for the administration of the system would be offset for the interest earned on the monies held on the central account. Some of the key elements of the proposal are:

- Progress payment retention moneys are deposited into a central trust account administered by the OSBC;
- Retention money would be released upon practical completion of the construction project with the agreement of the head contractor and relevant subcontractor;
- Release of money is dependent on the agreement of the parties or in the event of dispute by a court or expert; and
- Initial mediation in the event of a dispute would be handled by the OSBC.

The Inquiry does not presently favour such a structure because it seems that the interest earned on that money should go to the person entitled to the corpus of the fund itself. It ought to be regarded as an everyday business expense of the parties to pay for the account operating fees and if the interest is required to settle the accounts one way or another between the contractor and subcontractor then so be it. The Inquiry sees no reason at present why the money should go outside the system. However the Inquiry urges comments upon the proposal.

What is required at the same time is when there are disputes about the moneys in the retention accounts recourse should be had by summary application either to court or to a specially constituted tribunal. The Inquiry at the present time favours the augmentation and specialising of the CTTT so that a "flying squad" of highly experienced building inspectors may be utilised to resolve disputes, particularly at the low end of the scale concerning the entitlement to retention funds.

[29] The Small Business Commissioner's submission has been reproduced in terms.

Licensing of Commercial Builders

In order to construct a two bedroom cottage in the far west of NSW, a builder must hold a home builders licence. Yet a commercial builder engaged in the construction of a high rise office building in the bottom end of O'Connell Street in the CBD of Sydney, does not require a licence.

Readers are invited to contribute responses suggesting why that should or should not remain the position.

The most comprehensive and effective licensing system in the Commonwealth appears to have been established by the *Queensland Building Services Authority Act 1991* (the BSA Act).

Under the terms and conditions of the license, builders are only permitted to tender or compete for projects for which they have the required financial backing according to a sliding scale of project values. One important consequence of this is contractors who entered the industry are better equipped financially to withstand any financial adversity and therefore are in a better position to pay subcontractors. At the same time, the required backing for low cost projects is not an unreasonable barrier to entry at the low end of the industry, that is the low end of the scale of project values, as the financial worth of the new business improves, so too does its capacity to tender and contract for higher value projects in the approved scale.

The Housing Industry Association expressed its firm view that it would be undesirable to introduce into NSW a similar legislative framework to that currently operating in Queensland under the BSA Act.

The HIA noted in its submission that "the residential construction industry represents a distinct and unique component of the construction industry ……(and that) the commercial and regulatory environment in which the residential construction industry operates must be distinctly considered when undertaking the Inquiry".

The BSA Act may be accessed through the Inquiry website.

Queensland Building Services Authority Act 1991

The provisions in the BSA Act set it apart from the building regulation legislation in New South Wales in a manner that provides a holistic monitoring system for the benefit of both contractors and the public.

The BSA Act sets up a licensing scheme and an independent statutory Authority that funds its own operations on an almost revenue neutral basis. The principal public servant administrating the BSA Act contends that this structure together with other associate reforms

in the BSA Act have operated to reduce insolvency in the construction industry in Queensland.

Further, at the same time a contractor is seeking to be licensed, there is no impassable barrier to entry for those who want to start out in a small way tendering on the small jobs. Those entrants to the industry are required to demonstrate a relative low capital backing. Contractors can demonstrate their capabilities and build up solid capital foundations that will permit them to rise up through the licensing scale and take on bigger projects without the fear of undercapitalisation.

Key provisions in the BSA Act include:

- The licensing of all contractors seeking to undertake building work of any kind within Queensland (section 30 – Classes of contractors' licences).
- Rigorous financial assessments carried out on all contractors (whether commercial or residential) (Section 31(2)(b) and (c) – Entitlement to a Contractors' Licence).
- Continuing auditing requirements for all licence holders (Section 37(b)(3) – Applications for Renewal of Licence); (Section 53A – Satisfying financial requirements at renewal); Section 53B – False or misleading document about financial requirements).

The Authority takes careful steps to ensure that it is always in possession of reasonably current financial information relating to contractors and in conjunction with the above provisions is able to provide a strong framework of regulation to ensure that good builders come up through the ranks and protect those in the industry and the community.

Evidence to the Inquiry from the Queensland Building Services Authority suggests that the ranking capital requirements set out in the Queensland legislation, has had the effect of reducing the number of insolvencies. That is currently the view of the Adjudication Registrar and Executive Manager Contractual Development, although as he recognises, it is difficult to gather hard evidence to support this. Support for a Queensland licensing system has been almost uniform. The Housing Industry Association is opposed to the introduction of the Queensland model.

Questions/Issues for Comment

- **The Inquiry suggests that the key provisions upon which interested parties may wish to comment to the Inquiry are set out on the previous page. This is not to suggest a reading of the whole Act is not essential and any comments which readers may have upon any provisions of the Act and its likely suitability if applied in NSW are welcomed.**
- **Contractors and subcontractors experience in working within the Queensland framework is sought, in particular views on its effectiveness in better ensuring**

that builders in the industry have an appropriate capital backing, commensurate with the costs and risks of the project.

Terms of Reference: Paragraph 4

> ***In developing recommendations the Inquiry should consider the impact of Commonwealth jurisdiction over insolvency.***

The Inquiry is not at this point recommending any proposal which intersects, conflicts or requires any consideration of Commonwealth Laws. In particular the Inquiry is not recommending that any change be made to section 556 of the Corporations Act and in this respect it disagrees with the conclusion of the PriceWaterhouse Cooper Report drawn in 1996 that a priority claim be granted to subcontractors.

Terms of Reference: Paragraph 5

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

At the time of release of this Paper, the Industry Reference Group had met twice, initially to discuss the terms of reference and the approach of the Inquiry, and on the second occasion to discuss a draft version of this Paper. A further and earlier draft of this Paper has been sent to the Industry Reference Group.

Appendices

Terms of Reference

The construction industry in NSW has a high rate of insolvency. The industry accounts for fifteen per cent of businesses in NSW, but up to thirty per cent 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.

Trustee Regulation 2010 (NSW)

Extract

Clause 4 Guidelines for trustees

(1) For the purposes of section 14DB (1) of the Act, this clause sets out guidelines with respect to the investment of trust funds by trustees where the value of the funds subject to the trust does not exceed $50,000.

(2) The following investments are investments that a trustee might reasonably consider appropriate for the investment of trust funds:

(a) any public funds or Government stock or Government securities of the Commonwealth or any State,

(b) any debentures or securities guaranteed by the Government of New South Wales,

(c) any debentures or securities: (i) issued by a public or local authority, or a statutory body representing the Crown, constituted by or under any law of the Commonwealth, or of any State or Territory, and (ii) guaranteed by the Commonwealth, any State or the Northern Territory,

(d) any debentures or securities issued by the Northern Territory and guaranteed by the Commonwealth,

(e) interest-bearing deposits in a bank,

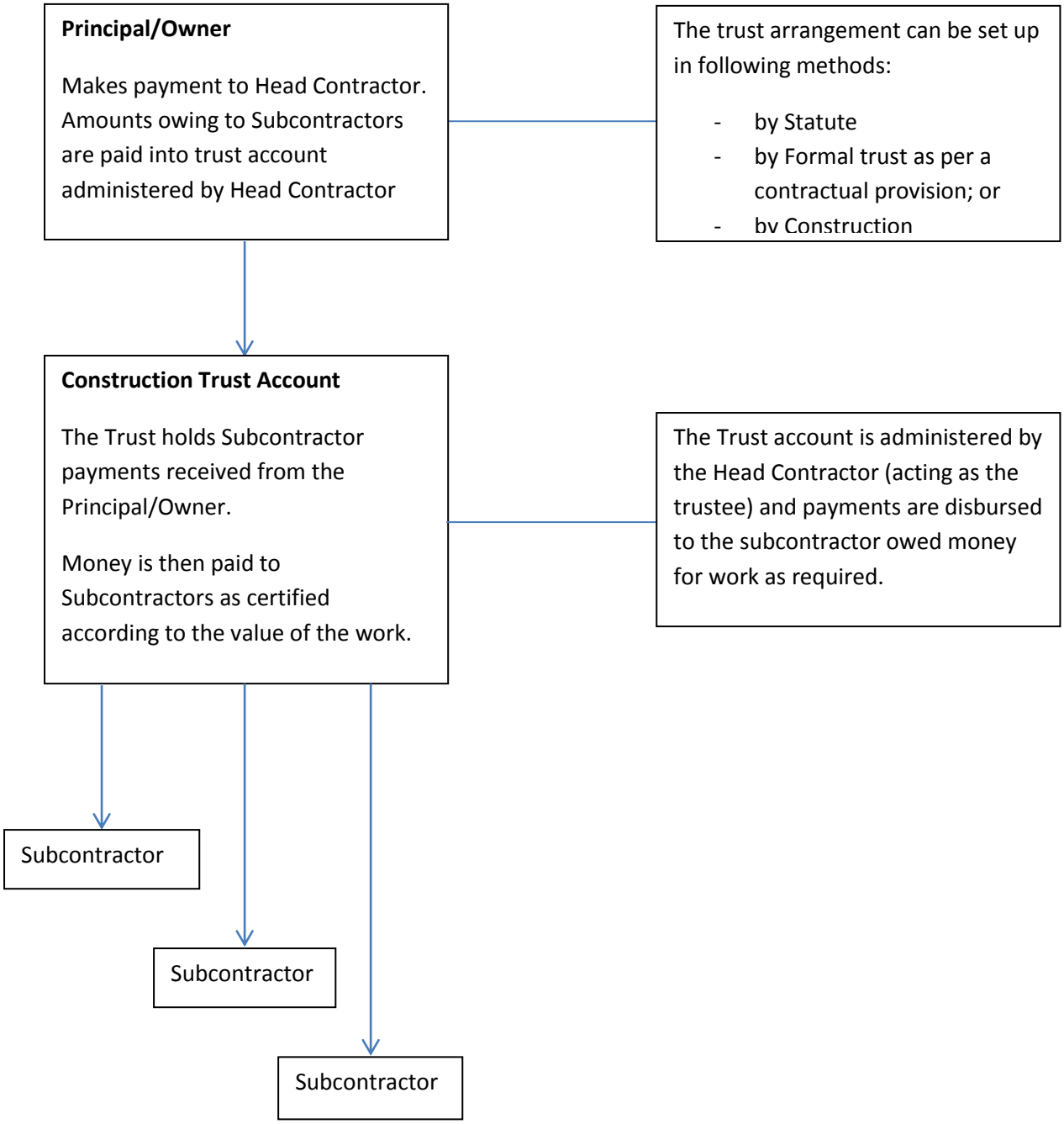
(f) any deposit with, withdrawable shares in, or loan of money to, an authorised deposit-taking institution.

Note. The obligations of a trustee are set out in section 14A of the Act, in other sections of the Act and in other rules and principles of law and equity. A trustee does not comply with the requirements of section 14A of the Act merely by investing trust funds in accordance with the guidelines set out in this clause. See, in particular, section 14DB (2) of the Act.

Industry Reference Group

Organisation	Representative
Civil Contractors Federation (NSW)	David Castledine
Master Builders Association (NSW)	Brian Seidler
Housing Industry Association	Melissa Adler
Law Council of Australia	John Cooper
Construction Forestry Mining and Energy Union - NSW	Brian Parker
Insurance Council of Australia	Justine Hall
NSW Small Business Commissioner	Yasmin King
NSW Chamber of Business	Luke Aitken
Unions NSW	Mark Morey
Insolvency Practitioners of Association of Australia	Michael Murray

Construction Trust Arrangement – Basic



Case Study: **Craigs Coastal Landscaping Pty Ltd**

Craigs Coastal Landscaping Pty Ltd was established in Wollongong in 1980. The husband and wife 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.

Mr Shane Duffy purchased the company in 1996 having finished his apprenticeship and worked for a number of years as a professional landscaper for the company. In its submission to the Inquiry, the company state that since 2009, seven companies that they have been contracted, 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.

It is only through the good will of their suppliers and using the equity they have in their home as security that the company 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 owners 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 owners 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 sufficient 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 owners contend that the ‘tier 1’ builders know that a lot of work is under-priced, yet willingly sign up the lowest bidder.

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Inquiry into Construction Industry Insolvency in NSW