



**THE LAW REFORM COMMISSION
OF WESTERN AUSTRALIA**

Project No 82

**Financial Protection in the Building
and Construction Industry**

REPORT

MARCH 1998

The Law Reform Commission of Western Australia was established by the *Law Reform Commission Act 1972*.

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ATTORNEY GENERAL

In accordance with the provisions of section 11(3)(b) of the *Law Reform Commission Act 1972*, I am pleased to present the Commission's report on financial protection in the building and construction industry.

WS Martin QC, Chairman

June 1998

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TABLE OF ABBREVIATIONS

Alberta Report	Alberta Joint Government/Industry Task Force on Builders' Liens: <i>Builders' Liens: Towards Greater Assurance of Payment</i> (1989)
Andersen Report	Andersen Consulting <i>Feasibility Study into the Proposal Prepared by the NSW Security of Payment Committee</i> (1993)
AS 2124-1992	Standards Association of Australia <i>General Conditions of Contract</i>
BISCOA (Qld)	The Building Industry Specialist Contractors Organisation of Australia-Queensland <i>Response to the Queensland Government November 1991 Green Paper: Security of Payment for Subcontractors in the Building and Construction Industry</i> (1992)
BISCOA (SA)	The Building Industry Specialist Contractors Organisation of Australia - South Australia <i>Comment on the Report of the Ministerial Working Party on Insolvency in the Building Industry-December 1990</i>
CIDA	Construction Industry Development Agency
CIDA Exposure Draft	Construction Industry Development Agency <i>Exposure Draft: Security of Payment Report</i> (March 1994)
CIDA Report	Construction Industry Development Agency <i>Security of Payment</i> (Final Report 1994)
Dorter and Sharkey	J B Dorter and J J A Sharkey <i>Building and Construction Contracts In Australia: Law and Practice</i> (2nd ed 1990 looseleaf service)
Ettinger	L P Ettinger <i>Trusts in the Construction Industry</i> (1989) 27 Alberta LR 390
Latham Report	Sir Michael Latham <i>Constructing the Team</i> (1994)
Macklem and Bristow	D N Macklem QC and D I Bristow QC <i>Construction. Builders' and Mechanics' Liens in Canada</i> (6th ed 1990 looseleaf service)
Newfoundland Report	Newfoundland Law Reform Commission <i>Report on the Mechanics' Lien Act: Certain Substantive Issues</i> (1990)
NPWC Position Paper	National Public Works Conference <i>Security of Payment</i> (1996)

NSW Green Paper	New South Wales Government Green Paper <i>Security of Payment for Subcontractors, Consultants and Suppliers in the New South Wales Construction Industry</i> (1996)
NSW Issues Paper	Business and Consumer Affairs Agency <i>Issues Paper on Financial Protection for Building Subcontractors</i> (1991)
Price Waterhouse	Price Waterhouse <i>Improving Security of Payment in the Building and Construction Industry</i> (1996)
Queensland Government DP	Queensland Government <i>Security of Payment for Subcontractors in the Building & Construction Industry</i> (1991)
SA Select Committee	Select Committee of the House of Assembly <i>Report of the Select Committee of the House of Assembly on the Operation of the Worker's Liens Act 1893</i> (1990)
SA Working Party	<i>Report of the Ministerial Working Party on Insolvency in the Building Industry</i> (1990)
Smith Report	C H Smith QC <i>Report of the Inquiry into the Building Industry of Western Australia 1973-1974</i>
SCGA Report	Legislative Council Standing Committee on Government Agencies Fifteenth Report <i>Review of the Builders' and Painters' Registration Boards</i> (Vol 1, 1987)
Vic Report	Parliament of Victoria Economic Development Committee <i>Fifth Report to Parliament: Security of Payments</i> (1994)

ABBREVIATIONS OF STATUTES

Alta	<i>Builders' Lien Act RSA 1980</i> (Alberta) c B-12
BC	<i>Builders Lien Act RSBC 1996</i> (British Columbia) c 41
Man	<i>Builders' Liens Act RSM 1987</i> (Manitoba) c B91
Ont	<i>Construction Lien Act RSO 1990</i> (Ontario) c C.30
Sask	<i>Builders' Liens Act 1984-85-86.</i> (Saskatchewan) cB- 7.1

Chapter 1

INTRODUCTION

1. TERMS OF REFERENCE

1.1 The Commission has been asked:

"To recommend what changes to the law, if any (other than contractors' liens and charges), should be adopted for the protection of the interest of subcontractors, workers and others in the building and construction industry in receiving payment for work done or materials supplied."

1.2 The terms of reference are broad and cover a wide range of persons engaged in the building and construction industry, including builders and head contractors. Because of the structure of the industry¹ owners and builders employ relatively few people in an employer/employee relationship. Normally most of the work is carried out by independent subcontractors. Subcontractors may supply material as part of their contract or they may supply materials alone. The terms of reference extend to "workers....in the building industry" and, for the purpose of the project, the Commission has construed "workers" as meaning employees of both the head contractor and subcontractors.

1.3 The genesis of the reference is contained in the Commission's recommendations in paragraph 78 of its report on *Contractors' Liens*² that:

- "(a) legislation providing for the registration of contractors' liens should not be introduced;
- (b) legislation providing for the creation of contractors' charges should not be introduced;
- (c) alternative proposals be examined by the Government for the protection of those engaged in the building and construction industries."

It is alternative proposals for protection that are now examined by the Commission.³

¹ Paras 1.5-1.7 below.

² Project No 54 (1974). See also para 1.35 below.

³ The project was given to the Commission following representations to the then Premier by employees and contractors in the building industry: Media Statement of the Attorney General 8.5.1985. A report has not been completed earlier because other projects have had a higher priority and work on the project was suspended for a period of time.

2. CONSULTATIONS

1.4 In December 1995 the Commission published a Discussion Paper and an Issues Paper, together with a Questionnaire, seeking comments on the issues raised by the terms of reference. 31 submissions have been received in response to these papers.⁴ The Commission gratefully acknowledges the help of those who have made submissions or who have otherwise assisted the Commission.

3. THE STRUCTURE OF THE BUILDING AND CONSTRUCTION INDUSTRY

(a) Development of the use of subcontractors

1.5 The structure of the building and construction industry has changed since the early 1950's and with it the contractual relationships of persons working in the industry.⁵ Where once much of the construction work was performed by employees of the builder, now the builder or head contractor normally carries out very little of the work with its employees.⁶ Instead the various works required to construct a building, whether a residence, office or industrial building, or to complete an engineering project are subcontracted out to persons who may in former times have been employees of the builder. Bricklayers, carpenters, plumbers, plasterers, electricians and other suppliers of services and materials are now usually independent subcontractors. The following reasons have been suggested for this development by the Industry Commission -

- * A firm relying on its own labour force is geographically restricted.
- * An intermittent workload causes difficulties in maintaining a permanent workforce.
- * It is not viable to maintain a workforce containing all the specialists that might be required from time to time.

⁴ The names of those who made a submission are listed in Appendix I.

⁵ According to the Smith Report at 8 subcontracting first began to emerge in the early 1950's when home building was buoyant and flourished between 1965 and 1971 when building activity expanded greatly. See also L V Mohyla *Construction in Australia: Law and Project Delivery* (Sydney: Law Book Co, 1996) 18-19.

⁶ Head contractors typically employ only about 10% of on-site labour: Industry Commission *Construction Costs of Major Projects* (Report No 8, 1991) 23.

- * A contractor with a small permanent workforce can concentrate on management and needs less working capital.⁷

Subcontracting also allows for greater specialisation in skills and equipment.

1.6 On large projects many subcontractors in turn subcontract to others to carry out part of their responsibilities. The contractual relationships in the project may therefore take the form of a pyramid with many of the people involved having no contractual relationship with the builder or head contractor at all. In effect, the modern builder has ceased to be a builder in the traditional sense and has instead become a project manager or organizer in return for a percentage of the construction price.

1.7 Because of the way finance for construction projects is organized before building commences it is unusual for an owner to become insolvent during the course of the work though payment may be held up for a long period of time. More commonly, it is the builder who gets into financial difficulties in which event the subcontractors may not receive payment if the builder goes into liquidation. As each stage of the building is completed the owner (or the owner's financier) makes a progress payment to the builder. Ideally, this money should be used to pay the builder's subcontractors with the balance retained for its profits and costs. However, a builder in financial difficulties may not pay the subcontractors on time and of course if the builder goes into liquidation it can be expected that subcontractors either will not receive or will lose their money or part of it. Payments received by a head contractor might also be used to meet payments on other projects or to reduce an overdraft facility. A similar situation might occur down the contractual chain.

(b) Contractual and payment arrangements

1.8 In the residential sector of the industry subcontractors generally contract directly with a builder or home owner. Usually the contracts between builders and subcontractors are oral but some contractors use simple standard works contracts.⁸

⁷ Ibid.

⁸ Contracts between owners and builders for home building work are governed by the *Home Building Contracts Act 1991* and must be in writing.

1.9 These arrangements also apply to the smaller projects of the commercial sector. For larger projects there is usually a process of formal tendering and contracts.⁹ According to one commentator on the Discussion Paper this process provides little security to the subcontractor due to:

- "1. the lack of control of eligible tenderers and therefore, a highly competitive environment;
2. onerous conditions of compliance;
3. reducing bargaining power due to the environment;
4. one sided contractual conditions in favour of the head contractor".

1.10 The industrial sector usually involves a process of formal tendering with written contracts. However, according to one commentator:

"Contract documentation is onerous with substantial penalties for failure to meet stated operational and performance criteria but such stringent conditions also provide clear guidelines on payment, offering greater security to the contractor who enters such an agreement."

1.11 In both the commercial and industrial sectors standard form contracts have been developed¹⁰ but according to one commentator they are not being properly utilised. One consequence of this is that there is no equitable allocation of risk between head contractors and subcontractors with, in most cases, subcontractors bearing a greater portion of the risk. Even where standard form contracts are used with clauses such as those, which provide that retention funds are to be held in trust, one commentator stated that it is "common practice not to comply with the trust provisions".

1.12 The commercial and industrial sectors also differ from the residential sector in the manner in which payments are made. In the residential sector, subcontractors are paid on a weekly or fortnightly basis.¹¹ Some subcontractors such as electrical contractors are paid on a unit price, for example, a price for each power point or hot plate installed. In the commercial and industrial sectors subcontractors make claims on a monthly basis with payment being made within about 30 days.

⁹ According to a survey published in the CIDA Exposure Draft Provider's Study 10 a large percentage of subcontractors in the survey operated without formal written contracts.

¹⁰ Such as JCC-C and SCJCC-C and AS 2124-1992 and AS 2545-1993.

¹¹ This may not always be the case and it has recently been claimed that payment periods may be as long as 120 days: footnote 34 below.

4. RECOURSE WHEN ONE PARTY DEFAULTS

1.13 In the event of the head contractor's insolvency, its subcontractors rank as unsecured creditors.¹² That is, their right is merely one in common with other creditors to lodge a claim in the bankruptcy. When the assets of the bankrupt have been realized, the subcontractor receives a dividend generally based on the quantum of its debt so far as the general assets extend on a basis of equality with other unsecured creditors.

1.14 A subcontractor cannot generally bypass the head contractor and have recourse against the owner because there is no privity of contract¹³ between the subcontractor and the owner,¹⁴ unless the contract between the head contractor and the owner confers a benefit on the subcontractor.¹⁵ The *Property Law Act 1969*¹⁶ provides that where a contract expressly in its terms purports to confer a benefit directly on a person who is not named as a party to the contract, the contract is enforceable by that person. All defences that would have been available to the defendant in an action to enforce the contract are available.¹⁷ However, it is not a defence to show that there is no privity of contract between the owner and the subcontractor or that no consideration moved from the subcontractor to the owner.¹⁸ Some standard form contracts, such as AS 2124-1992, provide for the owner to pay a subcontractor, usually a nominated subcontractor, money due to the head contractor in particular

¹² *Pritchett & Gold & Electrical Power Storage Co Ltd v Currie* [1916] 2 Ch 515.

¹³ The doctrine of privity of contract provides that only those who are parties to a contract may sue or be sued on it.

As a result of the decision of the High Court in *Trident General Insurance Co Ltd v McNiece Bros Pty Ltd* (1988) 165 CLR 107 the status of the privity doctrine in Australia is in a state of flux. If the view of three of the members of the majority prevails, the common law will provide a means of enforcing a contractual benefit notwithstanding lack of privity and lack of consideration on the part of the beneficiary: see generally J W Carter and D J Harland *Contract Law in Australia* 3rd edn (Sydney: Butterworths, 1996) 336-339.

According to P Watts *Does a Subcontractor have Restitutionary Rights Against the Employer?* (1995) 3 LMCLQ 398, 398, referring to *Investors Protection Co Ltd v Ray Courtney Architects Ltd* (1993) 7 PRNZ 1,:

"...the New Zealand Court of Appeal recently left open the possibility of a subcontractor's restitutionary claim against the employer, while rejecting an argument that such a claim would lead to a proprietary right against the relevant land."

¹⁴ *A Vigers Sons & Co Ltd v Swindell* [1939] 3 All ER 590.

¹⁵ *In re Holte; ex parte Gray* (1888) 58 LJQB 5.

¹⁶ S 11(2).

¹⁷ Each person named as a party to the contract must be joined as a party to the action: *Property Law Act 1969* s 11(2)(b). This means that although a subcontractor may be seeking to recover from the owner, the head contractor should be joined as a party to the action. This might provide a means of ensuring that the owner is not required to pay twice for the same work: once to the head contractor and secondly to the subcontractor.

¹⁸ *Westralian Farmers Co-Operative Ltd v Southern Meat Packers Ltd* [1981] WAR 241. See J Longo *Privity and the Property Law Act: Westralian Farmers Co-Operative Ltd v Southern Meat Packers Ltd* (1983) 15 UWAL Rev 411.

circumstances.¹⁹ While this standard form contract is used, for example, by the Department of Contract and Management Services, the Commission understands that the power to make direct payments is not often exercised.

1.15 One avenue open to a head contractor or subcontractor who suffers a loss as a result of default in payment is an action under the *Trade Practices Act 1974* (Cth) or the *Fair Trading Act 1987* (WA). The *Trade Practices Act 1974* provides that a corporation shall not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive.²⁰ A contravention of the prohibition renders the corporation or person liable to an action for damages by any party that has suffered a loss.²¹ Intention to mislead or deceive is not an element of the prohibition.²² If a director or financier of a developer makes a misleading statement to a head contractor or subcontractor about the financial viability of the developer, the director or the financier may be liable to the head contractor or subcontractor for any loss suffered as a result of that statement.²³

1.16 A head contractor or subcontractor who suffers loss as a result of a default in payment by a company may also be able to recover the sum lost from a director of the company. Under the *Corporations Law* individual directors are under a statutory duty to prevent insolvent trading by their company. If they fail to do so they are liable to a civil penalty and are personally liable to pay compensation to a creditor of the company. A director is liable if at the time the company incurs a debt -

- * he is a director of the company;
- * the company is insolvent or becomes insolvent by incurring the debt;
and
- * there are reasonable grounds for suspecting that the company is insolvent or would become insolvent.²⁴

¹⁹ See para 3.59 below. Such contracts would be subject to the law relating to insolvent liquidation of corporations (H A J Ford, R P Austin and I M Ramsay *Ford's Principles of Corporations Law* [27.220]-[27.310] or bankruptcy of individuals and preferences: 3 *Halsbury's Laws of Australia* [50-885].

²⁰ S 52. S 10(1) of the *Fair Trading Act 1987* is in the same terms but is not confined to a corporation and applies to a natural person.

²¹ *Trade Practices Act 1974* (Cth) s 82; *Fair Trading Act 1987* s 79.

²² *Hornsby Building Information Centre Pty Ltd v Sydney Building Information Centre Ltd* (1978) 140 CLR 216, 223, 228.

²³ See eg *Menhaden Pty Ltd v Citibank NA* (1984) 55 ALR 709.

²⁴ *Corporations Law* s 588G(1). For a discussion of these criteria see generally H A J Ford, R P Austin and I M Ramsay *Ford's Principles of Corporations Law* [20.110]-[20.180]. Statutory defences available to a director are discussed at [20.650].

In certain circumstances, the creditor may proceed in a court of competent jurisdiction to recover from the director, as a debt due to the creditor, an amount equal to the amount of the loss or damage.²⁵ These circumstances are that the company is being wound up and that the company's liquidator gives written consent to the commencement of proceedings.²⁶ The court may also give leave to commence proceedings.²⁷ Depending on the circumstances and documentation, it may be difficult to prove that conduct that was misleading or deceptive as required by the *Trade Practices Act 1974* occurred or that, under the *Corporations Law*, the corporation was insolvent at the time of incurring the debt. Further, as one commentator pointed out, subcontractors have limited financial resources to take legal action against a director who breaches these provisions.

5. CAUSES OF DIFFICULTIES

(a) Poor financial management

1.17 Research for the Royal Commission into Productivity in the Building Industry in New South Wales suggests that the industry is marked by under capitalisation²⁸ of head contractors and subcontractors with a high level of dependence on borrowed funds.²⁹ The Parliament of Victoria Economic Development Committee found that in Victoria the industry was marked by high gearing, inability to secure finance and inadequate working capital.³⁰ A reliable cash flow is therefore very important to those in the contractual chain. Too often, however, money paid:

"...to a contractor on one contract is siphoned off to pay creditors of another contract or used to invest in other projects.

"There have been occasions when a builder will enter into a contract where a loss is certain for the sole purpose of having a cash flow to cover past debts in anticipation of staying in business long enough to obtain a profitable contract before his insolvency becomes known."³¹

²⁵ *Corporations Law* s 588M(3).

²⁶ Id s 588R(1).

²⁷ Id s 588T.

²⁸ The CIDA Exposure Draft at 89 reported that approximately 45% of the 110 insolvent companies in a study conducted for CIDA had issued capital of \$10 or less.

²⁹ Queensland Government DP 11-13. According to the Andersen Report (12) the gearing ratio for small building companies is approximately 83% compared to 67% for business in other industries.

³⁰ Vic Report 18-19.

³¹ Queensland Government DP 15.

(b) The risks of a chain of contracts

1.18 Another cause of difficulty is the existence of the chain of contracts linking the owner, head contractor, subcontractors, employees and material suppliers. This chain of contracts is itself risky, with those at the end of the chain bearing the greatest risk. Direct contractual links significantly reduce the commercial risks for those involved because they permit direct payments. In a process which relies on a chain of contracts, the insolvency of one of those in the chain can have devastating effects on those waiting for money to flow down the chain. Two associations which made preliminary submissions to the Commission pointed out that in some instances "... contractors have gone into liquidation within hours of receiving progress claims on a project without any distribution to sub-contractors and if the sub-contractor is paid [the subcontractor is] often required to forfeit the payment by the liquidator".³² This underlines a general problem with the industry that head contractors use subcontractors' funds and assets as a credit facility.³³

(c) Payment delays create cash flow problems

1.19 Another difficulty drawn to the Commission's attention is that, despite contractual terms requiring payments to be made within 30 days of receipt of a progress claim, payments can be delayed for as long as 90 or 120 days.³⁴ This may be because the head contractor is surviving on the money due to the subcontractor. If possible, the only effective redress the subcontractor has is to increase its price to cover the cost of providing credit to the head contractor. Another reason for delays in payment is that the head contractor may not have received a progress payment from the owner. If it were to make a payment for work done or materials supplied before the progress payment had been received, it would either have to use its own capital or incur debt. In a poorly capitalised industry it is likely to choose to delay payments until a progress payment has been received.

³² The Master Plumbers & Mechanical Services Association of Western Australia; The Master Painters, Decorators & Signwriters' Association of Western Australia.

³³ The Parliament of Victoria Economic Development Committee also heard evidence of the problem in Victoria: Vic Report 29.

³⁴ According to a study published in the CIDA Exposure Draft, 5% of the accounts were paid more than 90 days after they were issued: Appendix B 14 Table 7. 34% were paid between 45 and 90 days after they were issued: *ibid*.

Hon A J G MacTiernan MLC (now MLA) stated in mid 1996 that a feature of the industry in this State is "...the unilaterally determined extension of payment periods routinely going from 30 days out to 90 days and now to 120 days": Western Australian *Parliamentary Debates* (1996) Vol 333, 3373.

(d) Misuse of funds

1.20 A submission also stated that retention funds³⁵ were being allocated to other projects and, consequently, that the security of these funds is placed at risk. The Parliament of Victoria Economic Development Committee found that these funds were also being misused in Victoria. The holding of these funds by a head contractor could be open to abuse by the contractor failing to hold the monies in trust, misdirecting or spending the funds or illegally retaining the funds after completion dates.³⁶

(e) Spurious disputes

1.21 It was also suggested to the Commission that disputes (which may sometimes be spurious) as to the standard of work or materials are used to delay payments to subcontractors so that the head contractor continues to have the use of the money until it is paid to the subcontractor and may even refuse to make payments to contractors.³⁷ Participants in the study reported that 14% of projects in 1992/1993 were affected by the use of spurious claims such as liquidated damages or rectification of allegedly poor quality work or materials. The rates for the various categories of participants were -

consultants	3%
contractors	12%
suppliers	14%
subcontractors	16%. ³⁸

While legal proceedings in the courts, such as the Small Disputes Division of the Local Court, can be used to deal with such disputes, these proceedings are claimed to be unsatisfactory because of the expense and delay involved and because the presiding officers do not have expertise in the contractual structure of the building and construction industry or construction methods or standards. Implementation of the reforms recommended in Chapter 3 might

³⁵ These are funds retained by the owner or head contractor to ensure proper performance of the contract. They may be used to complete the works if a contractor will not perform work, abandons the work or becomes insolvent.

³⁶ Vic Report 23.

³⁷ See the example cited by Hon A J G MacTiernan MLC (now MLA) Western Australian *Parliamentary Debates* (1996) Vol 331, 896-897 of a builder which boasted about the restoration work done on the facade on an historic hotel but refused to pay a plasterer involved in the work and even threatened to take legal proceedings against the plasterer. Ms MacTiernan stated that this was not unusual conduct for the builder and that she was aware of three plasterers who found themselves in a similar situation after undertaking work for it.

³⁸ CIDA Exposure Draft Appendix B 15 Question 23. Major contractors were not asked the question.

discourage spurious disputes. Apart from these reforms, the Commission does not intend to address the difficulties of the use of court proceedings to deal with disputes in the building and construction industry because the issue has ramifications beyond the scope of this project. In any case, alternatives to court proceedings, for example alternative dispute resolution procedures such as arbitration and mediation, are available and are presently used to settle disputes. The Parliament of Victoria Economic Development Committee found that dispute resolution procedures in standard form contracts were time consuming and expensive and not cost effective for minor disputes.³⁹ **The Commission suggests that these procedures should be reviewed by the organisations responsible for drafting the standard form contracts.**

(f) Unscrupulous contractors

1.22 Evidence given to the Parliament of Victoria Economic Development Committee confirmed that " ...many companies...deliberately go out of business to avoid their legal obligations, whether they be to subcontractors, to suppliers or to customers."⁴⁰ This is also a problem in Western Australia. One commentator on the Discussion Paper drew attention to the ineffective control of unscrupulous contractors:

"The current systems of financial and legal protection appears to be unable to deal with unscrupulous contractors. Members were of the view that there is little to stop elements of insolvent organisations re-establishing themselves as new entities. Poor or inappropriate management practices that sent the first organisation under may continue in the new enterprise."

The use of corporations in this way is known as the "phoenix company" problem. Typically a company is wound up or put into administration leaving unpaid debts. Shortly afterwards another company, a "phoenix company" with some or all of the original company's directors and operations, takes up the business of its predecessor. Usually it operates from the same premises or with the same staff as that of its predecessor but disclaims any responsibility for its debts.

1.23 Proposals have been made to increase the capacity of the Australian Securities Commission to take action against those who use phoenix companies to avoid responsibilities to creditors. These proposals involve giving the Australian Securities Commission power to

³⁹ Vic Report 21.

⁴⁰ Id 38.

disqualify a person from being a director of or managing a company for up to 10 years in various circumstances including if the Commission is satisfied that they were a director or executive officer of a corporation which was wound up with creditors not being fully paid.⁴¹ The proposals have not been implemented as yet.

(g) Bid cutting or shopping

1.24 Another form of conduct which can make a head contractor or subcontractors vulnerable to a loss is post tender negotiations or "bid cutting".⁴² This conduct can be used to force a head contractor or subcontractor to lower its price after a tender has been successful without any change in the work to be performed. "Bid shopping" may also occur. This involves a head contractor obtaining pre-tender quotes from subcontractors on the basis that the subcontractor's quote will be accepted if the head contractor's tender is successful. However, once the tender is successful, the head contractor shops for prices with other subcontractors. According to the Parliament of Victoria Economic Development Committee head contractors argue that they have not entered into a contract with the subcontractor and are free to negotiate a firm price with any subcontractor once they have been awarded the head contract and have clearly defined the scope of the subcontract works. The Committee noted that the Australian Code of Tendering (Interim) bans post tender negotiations but the Code is "rarely applied".⁴³

(h) Unfair allocation of risk

1.25 While a fair allocation of risk between head contractors and subcontractors would make the financial position of subcontractors more secure, according to the Parliament of Victoria Economic Development Committee the:

"...head contractor is usually able to off lay risk by allocating this to parties lower down the contractual chain. This can lead to financial risk being carried by the party often least able to shoulder it.

Subcontractors are usually the parties most affected by this problem. They invariably become involved in a project after the finance has been established and the contract

⁴¹ Commonwealth Attorney-General News Release 97/95 28 October 1995, *Clipping the wings of Phoenix companies*.

⁴² According to the CIDA Exposure Draft Appendix B 10 up to 42% of contracts are subject to post-tender renegotiation.

⁴³ Vic Report 23.

structure fixed. As a result contract conditions and payment terms are rarely set to their advantage which places them at greater risk."⁴⁴

This reflects the weak bargaining position of subcontractors and also, possibly, carelessness in accepting terms which involve an unfair allocation of risk. Examples of clauses which involve an unfair allocation of risk are ones which require a subcontractor to continue to work after a head contractor has defaulted on its obligations to them or clauses which make payment conditional upon further events outside the power of the payee such as pay when paid clauses.⁴⁵

6. THE EXTENT OF THE PROBLEM

1.26 The problem of security of payment for those in the building and construction industry has been examined in a number of Australian jurisdictions. None of the studies has been able to quantify the extent of the problem because of a dearth of statistical information. In one study of 110 company insolvencies over a six year period done for CIDA the combined deficiency was \$418 million, an average of \$3.8 million for each company.⁴⁶ 29 of these companies operated in Western Australia. Their total deficiency was \$39.15 million, an average of \$1.35 million per company.⁴⁷

1.27 The Economic Development Committee of the Victorian Parliament attempted to assess whether bankruptcies were more prevalent in the building and construction industry than in other industry sectors. However, the Committee was unable to obtain reliable statistics on the number of firms in the building and construction industry to identify ratios of insolvencies and to compare them with figures for other industries. A study by the Australian Bureau of Statistics, *Small Business in Australia*, which suggested that the building and construction industry suffered a lower number of bankruptcies than most other industry sectors was found to be of limited reliability because of shortcomings with the source of the data used in the study.⁴⁸

1.28 A survey done for CIDA sought information from participants in the non-residential sector of the industry on the single largest debt they had incurred arising from non-payment in

⁴⁴ Id 20.

⁴⁵ Para 3.77 below.

⁴⁶ CIDA Exposure Draft 89.

⁴⁷ Id Appendix C.

⁴⁸ Vic Report 6.

the last financial year (1992/1993). The average for all respondents was \$55,000. For various groups in the sector the average was -

major contractors ⁴⁹	\$23,000
contractors	\$49,000
subcontractors	\$60,000
consultants	\$50,000
suppliers	\$44,000. ⁵⁰

The same survey reported that in 1992/1993 the 219 participants had 177 contractor/clients fail. The 119 subcontractor participants had 101 contractor/clients fail.⁵¹

1.29 The Parliament of Victoria Economic Development Committee also conducted a survey in Victoria in 1993 of security of payment and related issues. Respondents to a questionnaire (which included head contractors, subcontractors, consultants and suppliers) reported average losses of 0.38% of their turnover: 0.28% for head contractors, 0.45% for subcontractors, 1.33% for consultants and 0.73% for suppliers.⁵² Unfortunately, the survey contains no information on the losses as a percentage of profit margins. In money terms the 54 respondents suffered losses of \$1,648,000 in 1992/1993, an average loss of \$30,518 per respondent.⁵³ The size of losses varied considerably between respondents. For example, 19% of the subcontractors who responded reported average losses of 0.45% of turnover, 26% reported losses of between 2 and 2.5% and 18% reported losses of over 3%.⁵⁴

1.30 The survey done for CIDA sought information from participants on the total amount of outstanding accounts receivable at the end of 1992/1993 and the percentage that was recoverable. The percentages of unrecoverable accounts receivable were -

subcontractors	6%
contractors	2%
consultants	7%

⁴⁹ That is, contractors with an annual turnover of more than \$8 million.

⁵⁰ CIDA Exposure Draft Appendix B 15 Question 22.

⁵¹ Id 12 Table 4.

⁵² Vic Report 14. The figures from a similar study conducted for CIDA (CIDA Exposure Draft Appendix B 19 Table 10) in the non-residential sector are lower than this. For actual bad debts (not just provision) the losses as a percentage of turnover in 1992/1993 were -

contractors (other than major contractors)	0.11 %
subcontractors	0.13%
consultants	0.56%
suppliers	0.13%.

⁵³ Vic Report 97.

⁵⁴ Id 14.

suppliers 3%.⁵⁵

The percentages for sums overdue and a cause for concern were -

subcontractors	9%
contractors	13%
consultants	15%
suppliers	5%. ⁵⁶

1.31 Respondents to the Victorian survey were asked to identify the reasons for their loss of money. Issues identified by respondents were -

"financial collapse	76%
misuses of monies	60%
unethical conduct	34 %
illegal conduct	29%
lack of protection provisions in contract	29%
late payments	26%
'pay when paid'	24 %
inadequate documentation	21 %
lack of funds	21%
dispute resolution	19%". ⁵⁷

7. LIENS AND CHARGES

1.32 The position of a creditor will be stronger where he has a lien or charge over assets of an insolvent debtor. At common law a lien arises in favour of a person who does work on movable goods and relates only to those goods. In the absence of a contractual provision, a person who does work on land or a building does not have a lien on the land for the work done or the materials supplied in the course of the work.⁵⁸ Some contracts may even provide that as soon as materials are brought on to the building site they become the property of the owner of the land. Such a provision is designed to prevent materials passing to the receiver or trustee in the event of insolvency of the head contractor or its subcontractors. In other cases, the intention of the parties will determine whether or not property in the materials has passed to the head contractor or builder.⁵⁹

⁵⁵ CIDA Exposure Draft Appendix B 13 Table 5.

⁵⁶ Ibid.

⁵⁷ Vic Report 16. The figures do not add up to 100% because respondents may have reported more than one reason.

⁵⁸ 3 *Halsbury's Laws of Australia* [1355].

⁵⁹ Dorter and Sharkey 5.600.

1.33 In those jurisdictions where liens exist for the protection of persons in the building industry,⁶⁰ they have been created by statute and are commonly known as contractors' liens. Legislation, which allows for a contractor's lien provides that such a lien is registrable over the land upon which the building works are carried out. Once registered it operates as an encumbrance against that land. Subject to limitations imposed by the enabling statute, a lien holder is entitled to sell the land over which the lien is registered and apply the proceeds in satisfaction of the debt secured by the lien, having regard to any other encumbrances registered before the lien.

1.34 At common law a charge operates as an encumbrance against money payable by one person to another in favour of a third person. In the absence of a contractual provision, a subcontractor who does work on a building project has no right to a charge in its favour over money owing to the head contractor under the head contract. As in the case of liens, in those jurisdictions where charges in favour of subcontractors exist, they have been created by statute.⁶¹ Because of the weak bargaining position of subcontractors contracts in this State do not normally provide protection for subcontractors by means of either a lien or a charge.

1.35 In 1974 the Commission recommended that legislation providing for liens should not be introduced in Western Australia because "the registration of a lien against land may be detrimental to an owner who is in no way at fault" by inhibiting the owner's right to transfer or mortgage his land,⁶² It also recommended that legislation providing for charges should not be introduced because it "would not materially assist subcontractors and would tend to create more difficulties than it seeks to solve".⁶³ The Commission stated that one possible difficulty was that charges legislation could make it harder for a contractor to finance a building project in its early stages because until a progress payment became due under the contract the contractor had to rely on its own resources. Commonly a contractor borrowed money secured by a floating charge over money to become payable under the contract. However, as a subcontractor's charge would take precedence over such a lender's security, "banks and

⁶⁰ For example, Ontario (Ont s 14); Alberta (Alta s 4); British Columbia (BC s 4).

⁶¹ In Queensland, the *Subcontractors' Charges Act 1974* provides for this type of charge. See also *Worker's Liens Act 1893* (SA) s 7.

⁶² Law Reform Commission of Western Australia Report on Contractors' Liens (project No 54 1974) para 35.

⁶³ Id para 57.

finance companies would probably be reluctant to lend money to any contractors but those of considerable substance".⁶⁴

1.36 The problems faced by subcontractors and employees are by no means unique to Western Australia and have been addressed in other jurisdictions in Australia, the United Kingdom, Canada and the United States of America. In Australia, there have recently been inquiries in this area in New South Wales,⁶⁵ Victoria,⁶⁶ South Australia⁶⁷ and Queensland.⁶⁸ The Construction Industry Development Agency has also examined the matter at the federal level.⁶⁹ Statutory protection for subcontractors of one form or another has been provided in all states of the United States of America and in all common law Canadian provinces. The following Chapter contains an overview of reforms and proposals for reform in a number of jurisdictions in Australia and overseas.

⁶⁴ Id para 41. For other difficulties see paras 43-56.

⁶⁵ New South Wales Business and Consumer Affairs Agency *Issues Paper on Financial Protection for Building Subcontractors* (1991).

⁶⁶ Parliament of Victoria Economic Development Committee *Fifth Report to Parliament: Security of Payments* (1994).

⁶⁷ *Report of the Select Committee of the House of Assembly on the Operation of the Worker's Liens Act 1893* (1990) and *Report of the Ministerial Working Party on Insolvency in the Building Industry* (1990).

⁶⁸ Queensland Government Discussion Paper *Security of Payment for Subcontractors in the Building & Construction Industry* (1991). The Commission understands that a committee of inquiry appointed to inquire into the same matter reported to the Queensland Government in late 1996. The Commission does not know whether its recommendations have yet been acted upon. Those recommendations are understood to have related principally to licensing conditions in the building industry.

⁶⁹ *Security of Payment* Final Report (1994).

Chapter 2

OVERVIEW OF REFORMS AND PROPOSALS FOR REFORM ELSEWHERE

1. FEDERAL LEVEL

(a) The CIDA Report

(i) *Introduction*

2.1 At the federal level of government, the Construction Industry Development Agency (CIDA) established a committee to report on security of payment in the construction industry. That committee reported in 1994.¹ The CIDA Report contains recommendations on a number of areas including corporate governance, project funding, tendering, contractual provisions and security under the contract. The CIDA Board endorsed most of its recommendations. The recommendations relevant to this Report are set out below.

(ii) *Statement of adequate project funding*

2.2 The CIDA Report recommended that the owner should provide a statement of adequate project funding arrangements when a tender is called.² In the CIDA Exposure Draft a study showed that debt arising from the collapses of the financier was "quite significant". Of those who responded to the study, 16% of respondents had debt outstanding from failure of the major source of finance. 13% of subcontractors had debt outstanding for this reason.³ The CIDA Board did not endorse this recommendation in precisely these terms. It recommended that an owner should be under an obligation to provide tenderers with a statement of how it proposes to fund the project.⁴ The statement would be provided by an officer of the company who was in a position to know the facts of the statement. It also recommended that the Code of Tendering (Interim Australian Standard AS 4120) be amended to "...accommodate the obligation for the client to provide tenderers with a statement of how it proposes to fund the project."⁵ So far as standard contracts are concerned, it recommended that consideration be given to inclusion in the contracts of:

¹ CIDA Report.

² Recommendation 5.

³ CIDA Exposure Draft 26.

⁴ Recommendation 5.

⁵ Recommendation 6.

- "• a provision that the principal be required to provide evidence of adequate project funding, as a pre-condition to commencement of work under the contract; and
- of a warranty as to the principal's capacity to pay the contract sum."⁶

(iii) *Managed contracts with direct payments*

2.3 The use of managed contracts was examined in the CIDA Report. It recommended that where a project manager is acting as agent for a disclosed principal and holds identifiable certified funds due to trade contractors, suppliers or consultants, those funds should be held in a common identifiable trust account in a financial institution.⁷ It also recommended that the main contract and the trade, supply and consultant contracts should clearly identify with whom the trade contractor, supplier and consultant is in contract and whether the construction manager is an agent for a disclosed or unnamed principal.⁸

(iv) *Contractual conditions*

2.4 The CIDA Report recommends that all contracts contain "proof of payment" clauses.⁹ The CIDA Report also concluded that proof of payment clauses in existing standard form contracts were inadequate. It therefore recommended that industry contract committees be asked to include an appropriate proof of payment clause in all head contracts based on the principles of:

- "• written acknowledgement by the entity lower in the chain that payment has been received; and
- that the entity has made due payments including wages and workers statutory entitlements."¹⁰

The CIDA Report also recommends that paid if paid clauses should not be used and that signatories to the Construction Industry In-principle Reform and Development Agreement

⁶ CIDA Report recommendation 7, which was endorsed by the CIDA Board as recommendation 7.

⁷ Recommendation 33. This recommendation was endorsed by the CIDA Board as recommendation 31.

⁸ Recommendation 34. This recommendation was endorsed by the CIDA Board as recommendation 32.

⁹ CIDA Report recommendation 16. This recommendation was endorsed by the CIDA Board as recommendation 15.

¹⁰ Ibid.

should ensure that conditions of tender prohibit the use of such clauses.¹¹ No recommendation was made with regard to "pay when paid" clauses.¹²

2.5 The CIDA Report draws attention to abuses of a provision in contracts relating to the payment of liquidated damages. It said that head contractors were requiring subcontractors to pay the total amount of liquidated damages payable by the head contractor under the head contract even though a subcontractor may have been only partially responsible for the delay which caused the damages to be incurred.¹³ To prevent this abuse from occurring, the Report recommended that standard form contracts should incorporate the principle that "no party in the contractual process should be liable for more than the cost of the consequences of its actions".¹⁴

2.6 At present some standard contracts provide for the suspension of the works because of an act or omission of the owner.¹⁵ Such clauses limit a head contractor's liability should it ultimately become necessary to terminate a contract because of a default by the owner. To ensure that such protection was provided, the CIDA Report recommended that all contracts should contain a right to suspend the work for failure to make payment, with a further right to terminate the contract if non-payment continued.¹⁶

2.7 The CIDA Report examined the use of retention funds and pointed out that subcontractors consider retention money to be unsatisfactory because it ties up cash flow and the money may be lost if the contractor becomes insolvent. The CIDA Board recommended that, except where government departments or agencies are involved, all contracts should contain:

"....a provision that the party holding security in the form of cash or retention moneys establish a common identifiable account in a financial institution into which security must be paid, and held in trust, in the absence of other mechanisms for payment of security in the event of insolvency."¹⁷

¹¹ CIDA Report 30.

¹² Id 31. These recommendations were endorsed by the CIDA Board as recommendations 17 and 18.

¹³ CIDA Report 36.

¹⁴ Id recommendation 24. This recommendation was endorsed by the CIDA Board as recommendation 23.

¹⁵ See eg AS 2124-1992 cl 34.1.

¹⁶ CIDA Report recommendation 25. This recommendation was endorsed by the CIDA Board as recommendation 24.

¹⁷ Recommendation 30.

This would prevent funds being lost on the contractor's insolvency but it would not overcome the concern of subcontractors that part of their cash flow is tied up.

(v) *Registration of builders*

2.8 In relation to the registration of builders, the CIDA Report recommended that a set of common criteria to assess the character, financial and technical capacity of those seeking registration should be developed.¹⁸

(vi) *Tendering*

2.9 The CIDA Report made a number of recommendations relating to tendering including that, for traditional contracts, the head contractor should state the main subcontractors at the time of tender and be bound to engage those subcontractors unless there are compelling reasons for not being bound. Subcontractors would also be bound by their tendered price.¹⁹

(b) National Agreement by Commonwealth, State and Territory Construction Ministers

2.10 In January 1996 the Commonwealth, State and Territory Construction Ministers endorsed a set of principles to improve security of payment in the building industry as a foundation for a national code of practice. These principles are designed to be core rights and obligations for ethical and fair dealing between participants in the industry. The principles are-

- * Participants have the right to receive full payment as and when due.
- * All cash security and retention monies should be secured for the benefit of the party entitled to receive them.
- * Payment periods lower in the contractual chain should be compatible with those in the head contract.

¹⁸ CIDA Report 7. This recommendation was endorsed by the CIDA Board as recommendation 2.

¹⁹ CIDA Report recommendation 11. The CIDA Board endorsed this recommendation as a best practice.

- * Outstanding payments to participants, to the extent consistent with Commonwealth and State legislation, should receive priority over payments to other unsecured creditors.
- * All construction contracts should provide for non-payment to be a substantial breach.
- * All construction contracts should make provision for alternative dispute resolution mechanisms.
- 1
- * Only those parties who have financial and technical capacity and business management skills to carry out and complete their obligations should participate in the industry.
- * All construction contracts in the contractual chain should be in writing.

The Minister for Works, Mr Board, has announced that the Western Australian Government has endorsed this package of strategies.²⁰

2.11 The Ministers also agreed on a range of measures to provide better protection to subcontractors and suppliers to public sector projects in Australia. These measures included more equitable payment provisions, protection of retention monies, proof of payment to subcontractors and pre-qualification of head contractors.

2.12 The National Public Works Council and the Australian Construction Industry Council were requested by the Ministers to review further measures to provide better financial protection. As part of the consultation process, the Ministers agreed to the release of National Public Works Council position paper on the area.

(c) NPWC Position Paper

(i) Introduction

2.13 The NPWC Position Paper sets out the eight principles adopted by the Ministers to improve security of payment in the building and construction industry.²¹ The paper also sets

²⁰ Western Australian *Parliamentary Debates* 15 May 1997 3089.

out proposals to implement a number of these principles, proposals that should be adhered to by all participants in the industry. Some of these proposals are set out below. The paper also sets out sixteen options, which could be used to deal with the problem of security of payment. Many of these are discussed in Chapter 3 of this Report.

(ii) *Right to full payment as and when due*

2.14 Implementation of this principle involves the development of contractual provisions to allow monitoring of claims and their payment. Contracts should contain "proof of payment" clause which involve written acknowledgment by the entity lower in the contractual chain that its claim has been paid and that it has made due payments including wages and workers' statutory entitlements.²² Clauses known as "paid if paid" clauses²³ should not be included in contracts.²⁴

(iii) *Protection of cash security and retention funds*

2.15 To secure cash security and retention funds, the paper proposes that contracts should include one or all of the following mechanisms:

- provision of bank guarantees for security of payment to Participants;
- cash retentions due from the Head Contractor to a Participant held in trust independently of the Head Contractor's other moneys until completion of the defects liability period;
- insurance cover in respect of outstanding Subcontractors' progress claims and retention moneys in the event of a collapse of a Head Contractor;
- all forms of Performance Guarantee provided under Construction Contracts should be available to satisfy unpaid Participants.²⁵

²¹ Para 2.10 above.

²² NPWC Position Paper 17-18.

²³ Para 3.77 below.

²⁴ NPWC Position Paper 18.

²⁵ Id 18-19.

(iv) Financial and technical capacity

2.16 To ensure that only those parties who have the financial and technical capacity and business management skills to perform their obligations participate in the industry it was proposed that all participants in the industry should develop:

- "• management and financial skills including an understanding of cash flow characteristics, resources, an understanding of planning and mobilisation;
- an understanding of the need for and use of adequate working capital;
- an understanding of the need for ongoing research and development;
- an understanding of the need for ongoing training; and
- skills enhancement and overall business and corporate planning.²⁶

2. NEW SOUTH WALES

2.17 In 1991 the Business and Consumer Affairs Agency published an issues paper on financial protection for building subcontractors. The issues paper sought comment on the following options.

- Enactment of legislation to make mandatory a trust provision in subcontractors' contracts, on the model of the current retention fund trust clause in the current building industry standard form contracts.
- Extension of the Building Services Corporation Insurance Scheme to a more realistic level. Any rise in cover would be funded by an annual levy on licences.
- Examination of funding options for ongoing education programmes for BISCOA members as to contractual rights, obligations and tendering techniques.

2.18 Since this paper was published, the New South Wales Security of Payment Committee has developed proposals to protect monies from misapplication and to ensure that monies

²⁶ Id 21.

flow down the building payment chain. The Committee proposed a "deemed" trust in which all monies received on account of the contract price for an improvement are held in trust by those receiving the monies for those to whom they owe money on account of goods or services provided for the construction of the improvement.

2.19 This proposal was reviewed by Andersen Consulting for the New South Wales government. The Andersen Report concluded that the proposal of the New South Wales Security of Payment Committee should not be adopted. It recommended that the New South Wales Government's Code of Practice for contractual payments should be monitored for effectiveness and, if appropriate, strengthened by the use of companion contracts and mandatory trusts for retention monies.²⁷ It also recommended that the Government should encourage the use of alternative dispute resolution in the building and construction industry and the increased training of members by industry associations.²⁸

2.20 An interagency committee, the Construction Policy Steering Committee, was set up to implement the recommendations of the Andersen Committee. It has proposed some modification of the Andersen Committee recommendations and that, in addition, statutory declarations should be used to ensure that payments have been made to subcontractors.²⁹

2.21 In October 1996 the new government in New South Wales published a Green Paper, Security of Payment for Subcontractors, Consultants and Suppliers in the New South Wales Construction Industry. According to the paper the Department of Public Works and Services found that unpaid monies, as a result of head contractor insolvencies on New South Wales Government financed projects, is in the order of 0.15% of expenditure. However, losses in the building sector are higher, averaging approximately 0.4 to 0.5% of total expenditure because of a greater use of subcontractors in building as against engineering works.³⁰

2.22 At present the New South Wales Government has in place a range of procedures and processes aimed at improving security of payments to subcontractors and suppliers in the government sector. Following Government consultation through the Construction Policy Steering Committee a series of contractual measures were introduced in mid 1995 into

²⁷ Anderson Report 39.

²⁸ Ibid.

²⁹ Vic Report 9.

³⁰ NSW Green Paper 4.

government construction contracts. These measures, which apply to subcontracts valued at \$25,000 or more, require the contractor to:

- "• Allow subcontractors to provide unconditional undertakings (bank guarantees) from financial institutions in lieu of cash security or cash retentions.
- Hold in trust any cash security or cash retention provided by a subcontractor in order to quarantine such moneys from the contractor's cash flow business.
- Pay subcontractors for work for which the contractor is entitled to be paid by the Principal within 7 days of such entitlement occurring, irrespective of whether the contractor had actually been paid or not. This has the effect of stopping "pay when paid" and "pay if paid" types of provisions.
- Pay interest on late payment, which should be no less than the interest set in the main contract.
- Include in the subcontract the Alternative Dispute Resolution (ADR) provisions contained in the main contract.
- Provide subcontractors with the right to view the payment and ADR provisions in the contract between the contractor and the contractor's principal. "³¹

2.23 Government agencies are also required to examine the level of capitalisation of contractors to ensure that they have adequate capital to withstand reasonable adverse events which might occur during the course of a project. Based on an approach adopted by the Singapore Government, the Department of Public Works and Services has adopted a *pre-qualification* requirement which sets the maximum value of work pre-qualified for at twenty times the net worth, that is surplus assets over liabilities, of the registrant.³² Other initiatives of the New South Wales Government are:

- "• reflective contractual clauses must be used to ensure that the same terms of payment, proof of payment and access to alternative dispute resolution (ADR) that exist between a client and a head contractor are enjoyed by the parties involved down the contract chain
- the requirement, included in the *Code of Practice*, that formal written contracts must exist for all subcontractors."³³

³¹ Id 6. The clauses are set out in Attachment A of the Green Paper.

³² Id 12.

³³ New South Wales Government Green Paper *The Construction Industry in New South Wales: Opportunities and Challenges* (1996) 20.

2.24 The New South Wales Government will also require government agencies actively to follow up claims of non payment made on their projects by subcontractors, consultants and suppliers in a consistent and systematic manner. This process includes requiring parties in a dispute as to payment to provide statutory declarations with the possibility of being prosecuted for making false statements in the declarations.³⁴ A standardised approach has already been adopted by Government agencies in the use of statutory declarations to provide proof of payments by head contractors to subcontractors. A pro-forma statutory declaration requires contractors to declare that they have made all outstanding payments to workers, subcontractors and suppliers as a pre-condition to the contractor receiving a progress payment from the principal. The statutory declaration also requires contractors to receive statutory declarations from their subcontractors and suppliers to the effect that they have also paid moneys due to their creditors.³⁵ To improve the effectiveness of the use of statutory declarations, the New South Wales Government will:

- "• Ensure the NSW Police Service have formal processes in place to investigate instances of breaches of the *Oaths Act* relating to the provision of statutory declarations.
- Amend the *Oaths Act* to provide for a separate and distinct set of penalties relating to breaches of the Act where pecuniary gain was sought. The penalties are to be aligned with those applying to breaches of the *Crimes Act* in the committing of a fraud, these being a maximum fine of \$10,000 and/or a maximum of 2 years imprisonment."³⁶

2.25 A "bottom up" mechanism, where payment is not made to a contractor by a principal until the contractor's creditors have given written advice to the principal that they have received all moneys due to them, was not supported by the New South Wales Government. It opposed this type of mechanism because of -

- * the significant administrative costs associated with the provision and vetting of proof of payment statements by contractor's creditors;
- * the ability of a creditor improperly to withhold such a statement which may have the effect of delaying payments to other subcontractors and to others down the contractual chain; and

³⁴ NSW Green Paper 10.

³⁵ Id 7.

³⁶ Id 10.

- * providing subcontractors with a form of veto power over payments due to a contractor would be likely to cause dispute levels to rise in the industry and delay cash flows down the contractual chain.³⁷

2.26 The New South Wales Government also proposes to examine the following options -

- * Establishing a centralised financial assessment procedure to enable Government agencies to access contemporary financial assessments of contractors.³⁸
- * Developing a coordinated pre qualification scheme for contractors and consultants.³⁹
- * Using long-term contractual arrangements between government principals and contractors to encourage contractors to enter long-term and therefore more stable relationships with subcontractors and suppliers.⁴⁰
- * Investigate insurance schemes, including mutual insurance fund schemes and payment bonds, designed to protect non-payments to subcontractors and suppliers. Proponents of the insurance measures have estimated the cost at 0.15% to 0.25% of project costs for a coverage of 50% of project value.⁴¹
- * Extending the coverage of the Government's *Code of Practice for the Construction Industry* to private sector projects. This would be done by requiring contractors wishing to work on government funded projects to demonstrate that their conduct on non-government funded projects generally complies with the Code.⁴²

³⁷ Id 18-19.

³⁸ Id 13.

³⁹ Id 13-14.

⁴⁰ Id 14.

⁴¹ Id 16.

⁴² Id 15.

2.27 As to the New South Wales Security of Payment Committee deemed trust proposal, the Government commented that:

"...the complexities associated with the mixing of trust moneys with other funds of a contractor, together with the impact of other existing regulations/laws on the status of such moneys, would inevitably result in a costly and complex dispute process. Therefore, recovery of trust funds in the event of insolvency is extremely unlikely, while existing legal remedies are available for recovery if insolvency is not at issue.

The practical benefit of trusts as proposed by the Security of Payment Review Committee was seen as having a strict regime in place to punish those who fail to pay and therefore breached their trust obligations.

Any such additional punitive regime is not considered appropriate at this stage".⁴³

The New South Wales Government rejected the use of liens and charges because they have the undesirable effect of tying up assets of innocent parties who are not involved in a dispute over payment in the case of liens, and blocking off cash flow in the case of charges.⁴⁴

2.28 Surety bonding was not considered to be a cost-effective strategy to address security of payment problems.⁴⁵ A review conducted in 1993 by Coopers and Lybrand for the National Public Works Council was inconclusive in that it found that surety bonding offered no substantive cost advantage over other forms of security currently being used by principals and clients in the industry. A major drawback was the need for the principal or client to substantiate their losses and/or the contractor's liability to the satisfaction of an insurer before moneys are made available. By contrast, under the existing security arrangements, access to such moneys is immediately available by calling up security.

3. QUEENSLAND

2.29 In May 1991 the Queensland Government convened a Construction Industry Conference to ascertain whether a solution could be found to the problem of the non-payment of subcontractors in the construction industry. To help the participants weigh up the pros and cons of the various options for reform the Government published a discussion paper⁴⁶ in

⁴³ Id 17.

⁴⁴ Id 17.

⁴⁵ Id 18.

⁴⁶ Queensland Government DP. See also Ch 1, note 68, regarding subsequent Queensland Government reports.

November 1991. The paper examines various options for reform relating to capitalisation and management underskilling, contract terms, the *Subcontractors' Charges Act*, dispute resolution and tendering practices. It also examines the use of trusts to protect payments and a number of forms of insurance.

2.30 No new reforms have been introduced in Queensland by legislation but new contractual arrangements and tendering processes have been implemented to protect subcontractors on Government projects as part of the State Purchasing Policy. The arrangements, which have been introduced, include -

1. Insertion of a special condition in contracts to provide for proof of payment to subcontractors. A head contractor must set up a payment recording system, which provides for a subcontractor to acknowledge that it has been paid all monies due and payable to it. The head contractor must also notify the government department of any subcontractor who has failed or refused to sign the record of payment or to whom no payment is yet due and payable.⁴⁷
2. Provision of statutory declarations that would provide a clear statement and record of the existing position between the head contractor and subcontractors, workers of subcontractors and suppliers. If a statutory declaration is not provided, the government department may suspend payments to the head contractor and require the contractor to show cause.⁴⁸
3. Mandatory use of standard form subcontract AS 2545 by head contractors where the provision of work exceeds \$50,000. If the value of work is less than \$50,000 the contract must contain a proof of payment clause.⁴⁹
4. The head contractor must deposit with the principal cash or an unconditional undertaking to the value of 5% of the contract sum for the primary purpose of satisfying subcontractors charges or set up a retention trust fund to hold subcontractors' securities and retentions.

⁴⁷ Price Waterhouse 59.

⁴⁸ Ibid.

⁴⁹ Ibid.

5. Tendering reforms including pre-registration of contractors with stringent criteria in respect of financial and technical capacity.

4. SOUTH AUSTRALIA

(a) Select Committee Report

2.31 There have been two reports in South Australia in recent years: one by a Select Committee of the House of Assembly⁵⁰ and the other by a Ministerial Working Party.⁵¹

2.32 The Select Committee examined the operation of the South Australian *Worker's Liens Act, 1893* under which workers, contractors and subcontractors are entitled to register liens over the land of a landowner who has consented to work being done on his land or for materials supplied for work done on his land. Workers and subcontractors can also claim a charge over money payable to the contractor or subcontractor by whom they are employed or with whom they have contracted.

2.33 The Committee concluded that the *Worker's Liens Act, 1893* was no longer effective and that it was "...a major impediment to the effective resolution of a builder's insolvency and that the current insolvency laws gave protection to workers."⁵² The Committee also concluded that "...it was inappropriate for suppliers of materials to the building industry to be in any different position to other suppliers of materials."⁵³ The Committee examined three other options: trust funds, direct payments and insurance schemes.

2.34 Two types of trust fund were examined: a central trust fund into which all payments for building works is paid and one in which each builder opens and operates a trust fund for each project undertaken. The Committee believed that the second option could be set up in standard building contracts and favoured self regulation by the industry.⁵⁴

⁵⁰ SA Select Committee.

⁵¹ SA Working Party.

⁵² SA Select Committee 7.

⁵³ Ibid.

⁵⁴ Id 6.

2.35 A direct payment system would involve direct payments by owners to subcontractors. The Committee favoured contracts being standardised to enable owners to pay subcontractors directly but once again by industry self-regulation.⁵⁵

2.36 An insurance scheme would involve a subcontractor in insuring against a builder becoming insolvent. The Committee concluded that a compulsory insurance scheme for "...labour only or small subcontractors and small suppliers of materials would provide a better level of protection for the industry than exists under the *Worker's Liens Act, 1893*."⁵⁶

(b) Ministerial Working Party

2.37 Following the report of the Select Committee the Minister for Housing and Construction formed a Working Party to advise him as part of a plan to examine insolvency in the building industry. To reduce the effect of building industry insolvencies, the Working Party recommended a four-point plan "...to reduce the exposure of individual participants to the insolvencies of others and to limit the flow on effect where an insolvency does occur":

"1. *Education*: as part of the licence requirements participants in the industry should demonstrate their understanding of the principles of risk management and the need to better manage their debtors. This understanding to be made part of the licensing provisions through the employment of adequately trained staff or to be made available to company directors and tradespeople by way of training courses. Similarly apprentices could be offered a business management elective during their final year of training.

2. *Builder's Licenses*: to be issued on an annual basis with stricter and more closely monitored financial reporting requirements. This would allow the regulators to more easily detect financial irregularities.

3. *Commercial Tribunal*: the jurisdiction of the Tribunal to be extended to include non-payment of subcontractors, its investigative powers to be extended to allow it to act immediately on complaints, and the inclusion of powers to investigate disputes (to establish if a bona fide reason exists for with-holding payment). The extension of its role would allow the Tribunal to provide an 'early warning' of financial problems.

4. *Trade Indemnity Insurance*: a broad industry wide insurance scheme to be established. Such a scheme would require universal participation, it may need to be mandatory, to be available at what the Working Party considers to be a reasonable

⁵⁵ Id 7.

⁵⁶ Ibid.

cost. This type of insurance would be effective in preventing the flow on effect of insolvencies."⁵⁷

5. VICTORIA

2.38 In 1994 the Economic Development Committee of the Victorian Parliament completed an inquiry into security of payment in the Victorian building and construction industry.⁵⁸ The Committee found that there was a lack of conclusive data to substantiate the problem⁵⁹ but that security of payment was an ongoing issue within the industry. It also found that a small number of individuals and firms had suffered financial hardship as a result of contractual losses further up the chain.⁶⁰ This may be because according, to the Minister for Housing:

"...the traditional practice in the building industry has been that in the event of the collapse of a contractor, unions and sub-contractors endeavour to extract payment from the Principal. While there is often no legal basis for this, as the contract is between the contractor and the Principal, industrial pressure has generally been applied and some level of payment made so that projects can proceed."⁶¹

2.39 The Committee concluded that there were a number of factors contributing to security of payment problems including "...contract management, business and financial management, tendering procedures, risk management, and business ethics" and the "informal culture underlying the way business is conducted."⁶² To address this cultural problem the Committee recommended that the following measures be taken:

- "• that industry training boards be strongly advised to include financial and business management training and ethics as a mandatory component of all courses in building and construction within Victorian TAFE and tertiary institutions;
- that other accredited training providers be strongly encouraged to follow the example in Victorian TAFE and tertiary institutions; and
- that industry associations increase their efforts to actively promote the need for training in basic cash management and accounting, business ethics, and the use and importance of contracts.

⁵⁷ SA Working Party 4.

⁵⁸ Vic Report.

⁵⁹ The Committee's investigations were severely hampered by the lack of statistical data to assess and compare financial losses and insolvencies in the building and construction industry and on an industry wide basis: id xv, Finding 1.2.

⁶⁰ Id xv, Finding 1.1.

⁶¹ Id xi.

⁶² Id xv, Finding 2.1.

The Committee further recommends that the Minister for Housing review the *Building Act* (1993) and consider an amendment requiring mandatory training for new entrants to the industry in the aforementioned areas as a precursor to registration in any trade in the Victorian building and construction industry.⁶³

2.40 Changes to tendering practices were also recommended by the Committee. It recommended that project specific and general tender selection criteria be used to assess and select consultants, head contractors and subcontractors. The project specific criteria would be used to assess financial and project management capabilities.⁶⁴ The general criteria would be used to assess past history of performance in meeting financial obligations.⁶⁵

2.41 The Committee also favoured the use of more equitable standard form contracts and recommended that government departments and agencies should use their purchasing power to enforce the use of these contracts.⁶⁶ To this end it recommended that government departments and agencies be required to use AS 2124 but that this standard form contract should:

- include clauses specifying timely realistic progress payments; equitable allocation of risk and measures designed to provide optimum protection for the client from head contractor default;
- include clauses specifying that a contractor shall not subcontract or allow a subcontractor to assign or subcontract any work under that contract unless
 - (i) the value of the contract is less than \$50,000; or
 - (ii) such subcontractors are nominated in writing by the client and subcontract documents used which incorporate AS2545 as the general conditions of contract;
- include proof of payment clauses that require the use of mandatory standardised statutory declarations; and
- not include clauses that refer to the postponement of payments such as "pay if paid" and "pay when paid".⁶⁷

So far as the non-government area is concerned, it recommended that all industry associations be encouraged to promote the use of "standard documentation".⁶⁸

⁶³ Id xvii, Recommendation 2.1.

⁶⁴ Id xvii, Recommendation 3.1.

⁶⁵ Ibid.

⁶⁶ Id xviii, Recommendations 3.1 and 3.2.

⁶⁷ Id xviii, Recommendation 3.1.

⁶⁸ Id xix, Recommendation 3.4.

2.42 The Committee recognised that proof of payment declarations could be abused. To deal with this problem in government projects it recommended:

- "(i) that all government departments and agencies be required to monitor the use of statutory declarations throughout the contractual process, and to satisfy themselves as to the integrity of such declarations before any payments are made. Where any inconsistencies are detected, the reasons should be determined, and if it is believed a declaration may be false, this should be referred to the Building Industry Task Force for further investigation; and
- (ii) that the Auditor General be required to monitor and conduct random audits of the use and integrity of statutory declarations made to government departments and agencies, and where any evidence of inconsistencies or false declarations is found, this be referred to the Building Industry Task Force for further investigation; and
- (iii) that the Building Industry Task Force under the Attorney-General be required to investigate any matter or inconsistencies referred to it concerning the use of statutory declarations contained in contract documentation; and where appropriate, institute legal action under the *Evidence Act* or other relevant Acts."⁶⁹

2.43 In Victoria one organisation, the Victorian Catholic Building Office, uses a standard contract⁷⁰ with modifications to provide a special procedure for proof of payments. Under this approach, progress payment claims by head contractors must identify amounts claimed for each section and trade item. The amount due to subcontractors for each section and trade item is then paid by the principal to the head contractor who must then pay subcontractors within a prescribed period of receipt of the sum from the principal. Once acknowledgement of payment from all subcontractors is received by the principal, the principal pays the balance of the claim to the head contractor.⁷¹

6. CANADA

2.44 In Canada all provinces have mechanics' or builders' lien legislation which provides a right to register a lien against any land benefited by the provision of labour and materials. The first legislation was enacted in Ontario and Manitoba in 1873. In more recent years, a number

⁶⁹ Id xix, Recommendation 3.5.

⁷⁰ JCC-C and JCC-D.

⁷¹ Price Waterhouse 60-61.

of provinces have supplemented this right with provisions with respect to trust funds. Some provinces also make provision for holdbacks in the hands of the owner.

2.45 The legislation relating to trusts generally provides that all sums received by a head contractor or subcontractor ("the trustee") on account of their contract price are trust funds in their hands for the benefit of their subcontractors, workers and suppliers ("the beneficiaries").⁷² The effect of a statutory trust is to transform what would otherwise be a debtor-creditor relationship into a fiduciary one. Failure to pay a debt is no longer merely a breach of contract, but a potential breach of trust. If the builder goes into liquidation the moneys are protected from the liquidator and preserved for the beneficiaries of the trust.⁷³ Such provisions usually augment contractors' liens,⁷⁴ but they can operate independently of them.

7. UNITED KINGDOM

(a) Introduction

2.46 In the United Kingdom a joint government and industry review of procurement and contractual arrangements in the Construction industry was established in 1993. Its report, the Latham Report, submitted in 1994, contains recommendations on a wide range of matters including security of payment in the construction industry.

2.47 The Latham Report recommended that certain conditions should be included in a modern construction contract including -

- * A specific duty for all Parties to deal fairly with each other, and with their subcontractors, specialists and suppliers, in an atmosphere of mutual co-operation.

⁷² There are trusts in Alberta, British Columbia, Manitoba, New Brunswick, Ontario and Saskatchewan: Macklem and Bristow Table of Concordant Statutes C6-C9.

⁷³ For example, see *Canadian Commercial Bank v Simmons Drilling Ltd* (1989) 62 DLR (4th) 243 which concerned a statutory trust under Saskatchewan's *Builders' Lien Act 1984*.

⁷⁴ It has also been recommended that trust provisions augmenting lien legislation be introduced in Newfoundland: Newfoundland Report 111.

- * A choice of allocation of risks, to be decided as appropriate to each project but then allocated to the party best able to manage, estimate and carry the risk.
- * Express provision for assessing interim payments by methods other than monthly valuation, that is, milestones, activity schedules or payment schedules.
- * Setting out the period within which interim payments must be made to all participants in the process, failing which they will have an automatic right to compensation, involving payment of interest at a sufficiently heavy rate to deter slow payment.
- * Providing for secure trust fund routes of payment.⁷⁵

2.48 The last condition would involve arranging a trust fund "...into which the client deposits payments for each milestone, activity schedule or interim payment period before the commencement of the relevant period."⁷⁶ Legislation would be necessary to ensure that if the head contractor failed, trustees would have a duty to make due payments out of the trust account to subcontractors for work done and materials supplied. If the client failed, the trustees would be required to pay the contractor, who would be contractually bound to pay the subcontractors.⁷⁷

2.49 This reform process led to the enactment of provisions relating to construction contracts in the *Housing Grants, Construction and Regeneration Act 1996* (UK). They apply to construction contracts⁷⁸ in writing⁷⁹ other than a contract with a residential occupier⁸⁰ or any other description of construction contract excluded from the operation of the Act by order of the Secretary of State.⁸¹ The Minister is also required by regulations to make a Scheme for Construction Contracts containing provisions about the matters referred to in the Act.⁸² Before

⁷⁵ Latham Report 37.

⁷⁶ Id 39.

⁷⁷ Id 95.

⁷⁸ That is, an agreement with a person for the carrying out of construction operations, arranging for the carrying out of construction operations by others, whether under sub-contract to him or otherwise or providing his own labour, or the labour of others, for the carrying out of construction operations: *Housing Grants, Construction and Regeneration Act 1996* (UK) s 104(1).

⁷⁹ Id s 107(1).

⁸⁰ That is, "a construction contract which principally relates to operations on a dwelling which one of the parties to the contract occupies, or intends to occupy, as his residence": id s 106(2).

⁸¹ Id s 106(1).

⁸² Id s 114(1).

making these regulations he is required to consult such persons as he thinks fit.⁸³ Where any provisions of the Scheme apply by virtue of the Act in default of contractual provision agreed by the parties, they have effect as implied terms of the contract concerned.

(b) Alternative dispute resolution

2.50 A party to a construction contract has a right to refer a dispute arising under the contract for adjudication under a procedure complying with the Act.⁸⁴ If the contract does not comply with these requirements, the adjudication provisions of a Scheme for Construction Contracts apply. Under the Act the contract must enable a party to give notice of his intention to refer a dispute to adjudication and provide for the appointment of the adjudicator and referral of the dispute to him within seven days of the notice. The adjudicator must be required to reach a decision within 28 days of referral or any longer period agreed to by the parties.⁸⁵ The adjudicator must be required to act impartially and be allowed to take the initiative in ascertaining the facts and the law.⁸⁶ The contract must also provide that the decision of the adjudicator is binding until the dispute is finally determined by legal proceedings, by arbitration⁸⁷ or by agreement. However, the parties may agree to accept the decision of the adjudicator as finally determining the dispute.

(c) Payment entitlement

2.51 Under the Act a party to a construction contract is entitled to payment by instalments, stage payments or other periodic payments for any work under the contract unless -

- (a) it is specified in the contract that the duration of the work is to be less than 45 days, or
- (b) it is agreed between the parties that the duration of the work is estimated to be less than 45 days.⁸⁸

⁸³ As part of this consultation process, the Department of the Environment issued a consultation paper, *Making the Scheme for Construction Contracts*, in November 1996.

⁸⁴ *Housing Grants, Construction and Regeneration Act 1996* (UK) s 108(1).

⁸⁵ With the consent of the party referring the dispute to the adjudicator, he may extend the period of 28 days by up to 14 days.

⁸⁶ *Housing Grants, Construction and Regeneration Act 1996* (UK) s 108(2).

⁸⁷ If the contract provides for arbitration or the parties otherwise agree to arbitration.

⁸⁸ *Housing Grants, Construction and Regeneration Act 1996* (UK) s 109(1).

The parties may agree the amounts of the payments and the intervals at which, or the circumstances in which, they become due. In the absence of such agreement, the relevant provisions of the *Scheme for Construction Contracts* apply.

2.52 Every construction contract must -

- (a) provide an adequate mechanism for determining what payments become due under the contract, and when, and
- (b) provide for a final date for payment in relation to any sum that becomes due.⁸⁹

The parties may agree how long the period is to be between the date on which a sum becomes due and the final date for payment. A contract must provide for the giving of notice by a party not later than five days after the date on which a payment becomes due from him under the contract specifying the amount, if any, of the payment made or proposed to be made and the basis on which that amount was calculated. If or to the extent that a contract does not contain these provisions, the relevant provisions of the *Scheme for Construction Contracts* apply.

(d) Procedure for withholding payment

2.53 A party to a construction contract may not withhold payment after the final date for payment of a sum due under the contract unless he has given an effective notice of intention to withhold payment.⁹⁰ The notice, which must be given not later than the prescribed period before the final date for payment, must specify the amount proposed to be withheld, each ground for withholding payment and the amount attributable to it. If the parties have not agreed on the prescribed period, the period is that provided by the *Scheme for Construction Contracts*. Where the notice is given but the adjudicator decides that the whole or part of the amount should be paid, the decision must be construed as requiring payment not later than seven days from the date of the decision or the date which apart from the notice would have been the final date for payment, whichever is the later.

2.54 Where a sum due under a construction contract is not paid in full by the final date for payment and no effective notice to withhold payment has been given, the person to whom the sum is due has the right (without prejudice to any other right or remedy) to suspend

⁸⁹ Id s 110(1).

⁹⁰ Id s 111(1).

performance of his obligations under the contract to the party by whom payment ought to have been made.⁹¹ The party in default must first be given seven days' notice of intention to suspend performance, stating the ground or grounds for suspending performance. The right to suspend performance ceases when the party in default makes payment in full of the amount due.

(e) Pay if paid clauses ineffective

2.55 A provision making payment under a construction contract conditional on the payer receiving payment from a third person is ineffective, unless that third person, or any other person payment by whom is under the contract (directly or indirectly) a condition of payment by that third person, is insolvent.⁹² Where a provision becomes ineffective, the parties are free to agree other terms for payment. In the absence of such agreement, the relevant provisions of the *Scheme for Construction Contracts* apply.

7. UNITED STATES OF AMERICA

2.56 In the United States of America various mechanisms are used to provide security of payment including payment bonding,⁹³ stop notices⁹⁴ and holdbacks.⁹⁵ A number of States have also banned bid shopping.⁹⁶ One means of doing this is by requiring head contractors to submit the names of subcontractors as part of its tender.⁹⁷

2.57 Federal legislation (the *Prompt Payment Act*) which applies to Government contracts provides that head contractors must be paid within seven days of the Government receiving a payment request. Subcontractors must be paid within seven days after the head contractor receives payment from the Government. To trigger the flow of money from the Government, the head contractor must certify in its request for payment that "payments to Subcontractors and suppliers have been made from previous payments received under the contract, and timely payments will be made from the proceeds of the payment covered by the certification, in accordance with their sub-contract agreements". A number of States in the USA have

⁹¹ Id s 112(1).

⁹² Id s 113(1).

⁹³ Para 3.59 below.

⁹⁴ Para 3.98 below.

⁹⁵ Para 3.101 below.

⁹⁶ Para 1.24 above.

⁹⁷ CIDA Exposure Draft 43-44.

enacted some form of Prompt Payment Act providing for payment periods to both head contractors and subcontractors. In some of these States the protection applies in both the private and public sectors. Most provide for payment periods in the range of 7 to 14 days, but some allow for up to 30 or 45 days.⁹⁸

2.58 The effectiveness of the *Prompt Payments Act* is increased by a provision of the *False Claims Act* which provide that any person who:

"knowingly presents, or causes to be presented, to an officer or employee of the United States Government....a false or fraudulent claim for payment or approval; or

knowingly makes, uses, or causes to be made or used, a false record or statement to get a false or fraudulent claim paid or approved by the Government...

is liable for a civil penalty".⁹⁹

The effectiveness of the prompt payment legislation is further enhanced by the *Contract Disputes Act*, which provides that a head contractor claimant which is unable to support any part of its claim due to misrepresentation of fact or fraud on the part of that head contractor is liable to the Government for an amount equal to the unsupported portion of the head contractor's claim plus all costs in reviewing the claim.¹⁰⁰

⁹⁸ See Price Waterhouse 83.

⁹⁹ Id 84.

¹⁰⁰ Id 85.

Chapter 3

RECOMMENDATIONS

1. SPECIAL PROVISION SHOULD BE MADE FOR THOSE IN THE BUILDING AND CONSTRUCTION INDUSTRY

3.1 In the Discussion Paper the Commission sought comments on whether the law should be amended to regulate the payment of head contractors, subcontractors, workers and others in the building and construction industry, particularly when the payment of unsecured creditors in other industries is unregulated. Most of those who responded to this question favoured providing special protection. At present terms and conditions of payment are subject to negotiation between the parties. They are not regulated by legislation. The retention of this unregulated position might be justified by basic societal values such as freedom of individual action and minimization of government interference or coercion. It might also be justified by the intrinsic advantages claimed to be offered by a well-functioning competitive marketplace, such as -

- the market's tendency to minimize economic waste by allowing for continuous individual balancing, through contractual relationships, of economic costs and benefits by participants in projects;
- the "carrot and stick" incentive the market provides for greater production efficiency; and
- the incentives it provides for innovation, including innovations in the means of financing projects.

3.2 The Housing Industry Association submitted that there was a lack of information either to establish the severity of the problem or to justify government intervention.¹ It also suggested that there should be no government intervention because "some studies suggest that the incidence of business failure in the building industry is no worse than for other industries". The Commission considered conducting a survey to gauge the need for financial protection in

¹ The Commission notes, however, that, notwithstanding this view, the Housing Industry Association has since introduced a bond scheme to provide protection for payments due to subcontractors and building suppliers: *The West Australian* 22 August 1997 4 "Hope for homebuyers".

the building and construction industry and obtained the assistance of the Australian Bureau of Statistics in assessing whether or not a survey was feasible. The Bureau carried out a feasibility study, which concentrated on identifying and assessing sources from which a representative sample for the survey could be selected. The Bureau officer who conducted the study concluded that:

"...there are no suitable sources, from which a representative population frame can be established, which would truly reflect all participants in the building and construction industry. The severe undercoverage caused by using any or all of three options for a survey would seriously undermine any results. For example, any results from such a survey which showed no problems with payments would be entirely inconclusive and unreliable."

Consequently she recommended that a survey not be conducted. The Commission accepted the recommendation and decided not to conduct a survey.

3.3 While statistical evidence on the extent of the problem is limited,² anecdotal evidence suggests that failures of those in the contractual chain cause serious losses to individuals or firms.³ The Commission considers that, even though it is not possible to assess the extent of the problem, the fact that deficiencies in existing security of payment arrangements result in serious harm to various individuals and firms warrants some form of legislative intervention. Further, the Commission does not consider that it is necessary to show that failures are more common in the building industry than in other industries in order to justify legislative intervention. There are other, more important factors that lead to the conclusion that legislative intervention is justified. These are discussed below. The Commission's assessment

² See paras 1.26-1.31 above.

³ For example, one industry association reported to the Commission that one of its members had lost \$499,000 since 1979 and another member had lost \$426,000 since 1980 as a result of 29 building company insolvencies.

See also various articles on losses suffered by subcontractors: *The West Australian* 16 June 1989 "Builders will stand by Mansard clients", *The West Australian* 16 June 1989 "Grim day for all after collapse", *The West Australian* 22 October 1990 "WA builders go for broke", *The West Australian* 20 September 1991 "Liquidator takes over at Interstruct", *The West Australian* 8 January 1992 "Progress on Geographe", *The West Australian* 28 November 1994 "MLC defends jittery suppliers", *The West Australian* 30 June 1995 "Bid to protect new-home buyers", *The West Australian* 17 January 1996 "Contractors win legal battle with casino", *The West Australian* 18 June 1996 "Big builder seeks help", *The West Australian* 19 June 1996 "Work to resume, Collier clients told", *The West Australian* 19 June 1996 "Newman set for key role in Smith Corp", *The West Australian* 25 June 1996 "Builder under cloud", *The West Australian* 28 June 1996 "Smith administrator favours 20c payout", *The West Australian* 27 August 1996 "'Phoenix' builder crashes", *The West Australian* 28 August 1996 "Failed builder's debts rise: accountant", *The West Australian* 31 August 1996 "Devil in the detail as ASC targets phoenix companies", *The West Australian* 19 September 1996 "Creditors vote to liquidate builder" and *The West Australian* 6 September 1997 "Failed builders banned by ASC"

of the best approach to adopt and its reasons for adopting or rejecting various approaches are also discussed below.

3.4 Grounds, which would justify legislative intervention, are -

- * The assumption that the "best" or most efficient allocation is achieved by free market forces rests in part upon an assumption that there is a "proper" allocation of bargaining power among the parties affected. Where the existing division of such bargaining power is "unequal" in this sense, it may be thought that regulation is justified in order to achieve a better balance. For various reasons, subcontractors have apparently been unable to deal with the problem of protecting payments due to them by making appropriate arrangements⁴ with builders or head contractors, which will protect them. Competition within the building industry is often fierce and subcontractors are loath to do anything which would jeopardize their chances of getting contracts. The Queensland Government DP concluded:

"While extreme 'rationalists' would argue that company failures are the product of the inefficient being removed from the market-place, this does not recognise that well established and highly regarded subcontractors can often be forced into insolvency because of the failure or default of another party in the contractual chain. This market failure occurs because there is a lack of certainty of arrangements, an ability to shift risk to parties without giving them a premium for accepting it, use of less than competitive tendering systems, an imbalance of bargaining power, an imperfect information for some parties and the use of legal processes that can be slow, costly and inappropriate to settlement of disputes.

⁴ Such as negotiating a clause in their contract under which the owner holds a proportion of the retention monies on trust for the head contractor as trustee for the subcontractors.

Other forms of protection are -

1. An unconditional undertaking. Cl 5 of Standards Association of Australia Subcontract Conditions AS 2545-1993 requires the head contractor to put up as security for payment an unconditional undertaking by a bank or insurance company to pay a certain amount in the event that the head contractor fails to pay the subcontractor,
2. A Romalpa clause (named after the case *Aluminium Industrie Vaassen BV u Romalpa Aluminium Ltd* [1976] 1 WLR 676 in which a clause of this kind was considered by the English Court of Appeal). This type of clause provides that ownership of materials does not pass from the supplier to the contractor until the supplier has been paid in full for the materials. If the contractor becomes insolvent before the supplier has been paid, the supplier still owns the materials unless they have become a part of the improvement. Its use is becoming more common in Western Australia but mainly by suppliers of very expensive items of plant.

It is easy to say that if subcontractors are aware of these shortcomings they should not enter into contracts. However, given the already existing imbalance of power, the reality is that they have no option, unless of course they were to collude in contravention of the *Trade Practices Act*.⁵

In the context of this inquiry, a better balance between the parties to a project might be achieved by providing statutorily that the system of payment of subcontractors should be based on a fiduciary relationship rather than a contractual one⁶ or providing protection by means of implied contract conditions.⁷

- * Unscrupulous head contractors and subcontractors distort the operation of the market place. For example, some head contractors and subcontractors, operating as a corporation, become insolvent leaving behind a trail of bad debts only to recommence business as another corporation.⁸ At present, the law does not prevent insolvent head contractors and subcontractors from operating a new corporate entity. As the Alberta Report points out:

"Contractors and subcontractors, who have little or no aversion to operating in this manner, can bid and take jobs without due regard to the profitability of the job since they live on cash flow instead of the job's profit margin. The argument, sometimes made, that competition by such contractors and subcontractors is good for the consumer is specious at best. There is already significant competition in all parts of the construction industry and margins are not unreasonably high. Those contractors and subcontractors who are indifferent about the solvency of their corporate entity transfer real costs to subtrades who remain unpaid and to consumers who are left with incomplete work."⁹

The problem of unscrupulous head contractors will be ameliorated to some extent by proposed changes to the *Builders' Registration Act 1939* which will give the Builders' Registration Board power to ban builders who have failed from setting up business under a different name¹⁰ but this legislation has not

⁵ Paras 1.17 and 1.18.

⁶ Paras 3.9-3.15 below.

⁷ Paras 3.74-3.92 below.

⁸ Paras 1.22-1.23 above.

⁹ Alberta Report 20.

¹⁰ Media Statement Minister for Fair Trading 22 August 1995.

been introduced as yet. In any case, it will not address the problem of unscrupulous subcontractors who use "phoenix" companies.

- * There are deficiencies in the information available to those in the industry. In an industry with a pyramid structure, regulation of the payment system is justified because those low in the structure do not know enough about the ability of those above them to meet their financial obligations or the consequences of their financial failure. The CIDA Report contains a number of recommendations to improve the regulation of corporations and the information available to head contractors and subcontractors. One such recommendation is that the Australian Securities Commission database be expanded to record relevant historical information on both companies and directors and to provide ready public access to that information.¹¹ It also recommended that when the Australian Construction Industry Pre-Qualification Criteria for Contractors and Subcontractors is reviewed, consideration be given to the inclusion within the Financial Capacity Criteria of detailed relevant information on the corporate history of directors and key management personnel.¹²

- * The legal relationships between the parties to large construction projects are complex with many of those providing services on credit having no contractual relationship with the ultimate source of funding, the owner or its financier. The ordinary contractual remedies are inadequate to deal with the complex interrelated claims involved in the typical construction project. As the Newfoundland Law Reform Commission points out:

"Notwithstanding the interconnected nature of this chain, relying solely on notions of contractual privity the parties at each level have payment and performance claims only against the parties in the construction pyramid immediately above or below them. However, parties may be greatly affected, indeed placed seriously at risk, by the actions of persons within the chain other than those with whom they have contractual relationships. If, for example, the owner refuses to pay for the work done on his premises, those at the bottom of the construction

¹¹ CIDA Report 8. This recommendation was endorsed by the CIDA Board as recommendation 3.

¹² Id 9. This recommendation was endorsed by the CIDA Board as recommendation 4.

pyramid, who, in fact, have done most of the work, have no contractual claim against him.¹³

- * In the non-residential sector of the industry the payment cycle exposes subcontractors to a high level of financial risk. For example, under standard form contract SC JCCA 1985, the payment cycle could be as long as 51 days. Under this contract, a subcontractor shall submit a claim to the builder for a progress payment once each month on a date specified in the contract.¹⁴ That day could be up to 31 days after completion of the works. The builder is required to pay the claim within 20 days of a receipt of the progress claim.¹⁵ Further a subcontractor is not entitled to suspend work unless default in payment continues for seven days after the subcontractor gives the builder notice that work may be suspended if payment is not made within those seven days.¹⁶ Therefore, before the subcontractor is legally entitled to cease work, the value of work or materials at risk can be that which has accumulated over a period of up to 58 days. In the house building sector of the industry, it has been reported that payment periods routinely have gone out to 120 days.¹⁷

- * Subcontractors have a special role in the building and construction industry. At present very few head contractors perform much of the actual building work. Subcontractors carry out most of the construction work in both the house building sector and the construction industry. The subcontractor has by its work and materials made a major contribution to improving the value of the owner's land and the services and materials they supply, once supplied, lose their separate identity and become part of the land,¹⁸ yet the subcontractor might not be paid for months after the completion of the contract. One commentator suggested that, as a result of this structure, subcontractors carry 90% of the financial risk of projects.

¹³ Newfoundland Report 1.

¹⁴ CI 10.01.

¹⁵ CI 10.02. According to a study published in the CIDA Exposure Draft, only 18% of accounts issued by subcontractors were paid within 30 days of issue: Appendix B 14 Table 7.

¹⁶ SC JCCA 1985 cl 10.07.01.

¹⁷ Hon A J G MacTiernan MLC (now MLA) Western Australian Parliamentary Debates (1996) Vol 333 3373.

¹⁸ This argument also applies to others who have contributed to the project such as those who provide finance, legal advice, design or other services.

- * Alternatives to regulation are unsatisfactory. For example, there are problems in subcontractors taking unilateral steps, such as obtaining credit insurance, to protect themselves. The Building Industry Specialist Contractors Organisation of Australia (BISCOA) informed the Commission that credit insurance is commercially available, but at 3% of the subcontract price it is felt by members to be too expensive as their margin of profit on most jobs is so small in comparison. Those that do take this step to protect themselves will be disadvantaged during any bidding process. The Housing Industry Association developed a credit indemnity scheme which offered an insurance-type protection for its subcontractor members but the scheme foundered.¹⁹ Two commentators suggested to the Commission that in an industry "rife with unethical and unconscionable behaviour", subcontractors are generally fearful of using existing legal remedies for fear of not being considered for the next project.²⁰

- * The building and construction industry has features which distinguish it from other industry sectors such as the retail industry. While there may be a level of bad debt in the retail industry, much of its income comes from cash transactions and a large base of customers. Traders that suffer financial loss as a result of bad debts are more likely to do so as a result of bad management. On the other hand, in the building and construction industry subcontractors are likely to work predominately for one head contractor or be committed to one head contractor for a number of weeks' work. The cash flow base is necessarily narrower than in the other industries such as the retail industry and it is more difficult to sustain defaults by debtors.

- * Other industries have trust funds to protect money received by participants where it is received for or on behalf of another person.²¹

¹⁹ Para 3.94 below.

²⁰ The Master Painters, Decorators & Signwriters' Association of Western Australia; The Master Plumbers & Mechanical Services Association of Western Australia.

²¹ Legal profession: *Legal Practitioners Act 1893* s 34; real estate agents: *Real Estate and Business Agents Act 1978* s 68; settlement agents: *Settlement Agents Act 1981* s 49; finance brokers: *Finance Brokers Control Act 1975* s 48; debt collectors: *Debt Collectors Licensing Act 1964* s 15; securities dealers: *Securities Industry Act 1980* (Cth) s 73, and *Corporations Act 1989* (Cth) s 866; education service providers: *Education Service Providers (Full Fee Overseas Students) Registration Act 1991* s 6. See also para 3.14 below for a trust to protect funds received by travel agents for airline tickets payable to an airline.

- * A more secure payment system might encourage trades people who have left the industry because of problems with unpaid debts to return to the industry.²²

3.5 For the reasons given in the previous paragraph, the Commission has concluded that the law should be amended to regulate the payment of head contractors, subcontractors, workers and others in the building and construction industry. The following sections of this chapter contain a discussion of various approaches to regulation examined in the Discussion Paper and the Commission's recommendations on whether they should be adopted as a means of providing protection for payments to head contractors, subcontractors, workers and others in the building and construction industry.

3.6 In comments on the Discussion Paper, the Housing Industry Association suggested that the proposed introduction of compulsory insurance for residential building work would indirectly assist those in the contractual chain as well as home builders. The Housing Industry Association submitted that this scheme, which has since been introduced,²³ will reduce builder insolvency in the housing industry to "almost negligible proportions" because builders will not be able to construct new homes or undertake major renovations unless they can obtain indemnity insurance coverage. To do so they will need to provide financial details to satisfy the scheme's underwriters that the builder is financially viable and qualifies for underwriting. If a builder cannot prove its financial viability to the satisfaction of the underwriter, it will not be able to obtain an indemnity certificate and will not be able to operate or, if it can operate, its operations will be restricted. The Association acknowledged, however, that this would not eliminate builder insolvencies.²⁴ Where a builder became insolvent indemnity insurance would protect the home builder from the risk of losing an amount paid by way of deposit up to a limit of \$13,000 or the risk of loss resulting from non-completion of the work as a result of that insolvency. However, it will not provide any protection for subcontractors who suffer loss as a result of the insolvency. Compulsory builders indemnity insurance will therefore not

²² The Housing Industry Association saw this as one advantage of introducing a voluntary bond scheme to protect subcontractors and building suppliers: *The West Australian* 22 August 1974 "Hope for homebuyers".

²³ See *Home Building Contracts Amendment Act 1996* which amends the *Home Building Contracts Act 1991* by inserting a new Part 3A - Home Indemnity Insurance. The amendment came into effect on 1 February 1997.

²⁴ In fact, another commentator, the Australian Society of CPA's Centre of Excellence for Insolvency and Reconstruction reported that there had been "instances of companies failing even when insured, and we presume vetted by an underwriter."

eliminate the need to provide protection for financial payments in the residential sector of the industry.

2. COST/BENEFIT ANALYSIS OF RECOMMENDATIONS

3.7 The Commission has carried out its examination of this project by analysing the causes of the difficulties which led to the matter being referred to it and determining which of various options for reform are likely to provide the most effective means of remedying or ameliorating those difficulties. It has taken into account the costs associated with the various options for reform and has kept in mind the need to ensure that the recommendations it makes do not unnecessarily add to the cost of building and construction. The Commission has not carried out a cost/benefit study of the options for reform because it is doubtful whether a full relatively accurate cost/benefit analysis could be carried out. Much of the necessary data, for example, data concerning the number and amount of payment defaults, the cost of late payments and spurious claims is not readily available and it would be prohibitively costly to obtain it.

3.8 The Commission does not believe that the approach it has recommended in this report will result in an overall increase in the cost of building and construction in Western Australia. Its recommendations should have no major net cost effect on those who comply with the scheme proposed by the Commission. The changes recommended in the law are likely to have the effect of reducing the amount of loss caused by defaults in payments, late payments and spurious claims. This reduction in loss should more than offset any additional costs incurred as a result of more stringent accounting requirements or any audit requirements that were introduced. The reasons for these beliefs are set out in this Chapter where the Commission's recommendations are discussed.²⁵

3. STATUTORY TRUST

(a) A trust scheme should be introduced

3.9 One option for reform examined in the Discussion Paper was to provide statutorily that all sums received by a head contractor or subcontractor ("the trustee") on account of its

²⁵ Para 3.16 below.

contract price are trust funds in its hands for the benefit of its subcontractors, workers and suppliers ("the beneficiaries").²⁶ This imposes a fiduciary relationship on what would otherwise be a debtor-creditor relationship.²⁷ Failure to pay a debt is not merely a breach of contract, but a potential breach of trust.

3.10 In some jurisdictions, the legislation goes further and provides that moneys in the hands of the owner for the purpose of the project are trust moneys. This is done by providing, for example, that where sums payable to a contractor by the owner become payable on the certificate of a person named in the contract, upon the issuance of the certificate, an amount equal to the sums so certified which is in the owner's hands or which subsequently comes into the owner's hands²⁸ shall be a trust fund for the benefit of the contractor.²⁹

3.11 Generally, in the case of a head contractor or subcontractor, trust schemes provide that a trust arises when the contract moneys are received by them. Usually this is when the moneys are in their hands but it can arise when moneys are owing to the contractor on account of the contract price even though they have not been paid to the contractor.³⁰ As a result, if, for example, moneys owing to a contractor under a contract for the project are paid into court, the moneys are deemed to be impressed with the trust and must be held for the benefit of the beneficiaries.³¹ It also means that any money received from the owner by the trustee in bankruptcy of the head contractor on account of the contract price is subject to the statutory trust and is not the property of the bankrupt. The money is not therefore divisible among the trustee's creditors until the beneficiaries under the trust are paid.³²

²⁶ A trust scheme may provide that until the beneficiaries of a trust are paid for work done or materials supplied, the trustee may not appropriate trust moneys for its own use except as permitted by the statute creating the scheme.

²⁷ A creditor/debtor relationship and a beneficiary/trustee relationship can coexist: see *Stephens Travel Service International Pty Ltd v Qantas Airways Ltd* (1988) 13 NSWLR 331, 340-341.

²⁸ For example, where a payment is made to the owner by its financier.

²⁹ Ont s 7(2). This legislation also provides that all sums received by an owner that are to be used in financing a project, including any amount that is to be used in the payment of the purchase price of the land and payment of prior encumbrances, constitute, subject to payment of the purchase price of the land and payment of prior encumbrances, a trust fund for the benefit of the contractor. Until the contractor is paid, the owner cannot appropriate any part of the trust to its own use: id s 7(1) and (4).

³⁰ Macklem and Bristow 9-21.

³¹ Id 9-21 to 9-22.

³² Id 9-23 to 9-24.

3.12 A trust usually only applies to money received on account of the contract price. It therefore does not apply to money received by, for example, an owner from a head contractor for damages for breach of contract.³³

3.13 At present some standard building contracts contain trust clauses relating to some payments. In *KBH Constructions Pty Ltd v Lidco Aluminium Products Pty Ltd and others*³⁴ the Supreme Court of New South Wales held that a clause under which the interest of the builder in the amount retained was "fiduciary as trustee"³⁵ presupposed the existence of trust property and required the property to be held on trust. The decision made it clear that contractors who hold retention moneys governed by such a clause do not have an unfettered right to use them. In England, it has been held that a similar clause impresses the retention monies with a trust which remains valid notwithstanding the head contractor's insolvency and thus the subcontractor's interest in those monies is protected.³⁶

3.14 While the parties to a contract could include in the contract provisions setting up trust accounts for payments on account of the contract price they rarely do so. They are not, for example, contained in standard form contracts such as AS 2124-1992, which is used by the Department of Contract and Management Services for government building contracts. Trusts have, however, been used by businesses in other industries to protect payments due to them. For example, a contractual arrangement between Qantas and travel agents provides that all "...moneys collected by the Agent for transportation and ancillary services sold under this Agreement, ...shall be the property of the Carrier and shall be held by the Agent in trust for the Carrier".³⁷

3.15 Although a majority of those who commented on the issue were opposed to trusts, in view of the advantages of a trust scheme set out below, the Commission **recommends** that a trust scheme be established statutorily in the building and construction industry. A statutory trust has the following advantages -

³³ Id 9-27.

³⁴ (Unreported) 27 June 1990.

³⁵ SCJCCA 1985 (clause 10.24.05).

³⁶ *Re Arthur Sanders Ltd* (1981) 17 BLR 125.

³⁷ *Stephens Travel Service International Pty Ltd v Qantas Airways Ltd* (1988) 13 NSWLR 331, 337.

1. It provides a means of ensuring that a head contractor and subcontractors are paid for their services and for materials supplied while keeping contract moneys within the control of the parties to the project.
2. It imposes ethical standards on the payment of participants in the industry for work done or materials supplied in an industry which has failed to use self-regulation to control the use of various unfair or unscrupulous practices.³⁸
3. It reinforces good practice in the distribution of funds for a project to the participants in the project and is consistent with the concept of cooperative contracting, which is seen as way of improving the efficiency of the industry.
4. Because the moneys are held in trust, they cannot be seized or frozen by a receiver or liquidator of the trustee or the trustee of the estate of a bankrupt trustee.³⁹ This means that the position of a person further down the chain can be secured and the payment of funds downward can still take place because the project funds held in trust will not form part of property distributed in the bankruptcy or winding up of the trustee.
5. A wider range of remedies is available for a breach or possible breach of trust than for a breach of contract.⁴⁰
6. It may result in a speedier resolution of disputes between, for example, a head contractor and a subcontractor, because generally the head contractor cannot withdraw money from the trust fund until all the claims of the fund's

³⁸ See paras 1.19-1.24 above.

³⁹ *Bankruptcy Act 1966* (Cth) s 116(2)(a). See also H A J Ford and W A Lee *Principles of the Law of Trusts* 3rd edn (Sydney: Law Book Co, 1996) para [14100].

⁴⁰ Trustees are civilly liable to restore the trust funds and to make good any loss caused by a breach of trust. Other remedies are -

1. Proceedings to compel the trustee to perform its duty or protect the beneficial interest in the trust property.
2. Proceedings to remove a trustee and appoint a new trustee in its place.
3. An order that trust moneys be paid into court.
4. An injunction restraining a breach of trust.
5. The appointment of a receiver of the trust property.
6. A personal action against a third party who has received trust property. The recipient of the property wrongly distributed may plead that it received the property in good faith and has so altered its position.
7. In certain circumstances, tracing or following the trust property into the hands of the person who received it.

beneficiaries have been met. It removes the incentive for those holding funds to create artificial disputes and resolve them through purely commercial pressure.

7. For the same reason, it may result in speedier payment of subcontractors.

3.16 Trust schemes have been subject to a number of criticisms. One is that they may not be simple to administer and that there may be substantial additional costs associated with administering them. The Commission is not convinced that administration will be a significant problem because the scheme it recommends be adopted in this report merely superimposes a fiduciary duty on a contractual relationship as has already been done in some standard building contracts in relation to retention funds. Additional accounting requirements will be limited to requiring each trustee to keep a trust account for project funds for each project separate from its general banking account.⁴¹ Doing this will not necessarily require any more stringent booking keeping than is now required for the proper running of a business or to comply with taxation laws. Even if there were increased costs they are likely to be offset by the interest received on the trust moneys while they are held in trust. Further, any additional accounting costs are unlikely to increase the cost of building because those costs are likely to be more than offset by a more secure payment system which will do away with or reduce the need to build into the contract price a sum to cover defaults or delays in payment.⁴² The New South Wales Security of Payment Committee claims that conservative estimates of cost savings of a more secure payment system are five per cent of current gross project costs. It argues that this can be demonstrated by the tender price reductions for direct payments from government on building contracts as compared to project costs on private contracts. This difference exists because default costs and late payment costs are built into the industry's pricing structure for private contracts but not for government contracts. If the risks are reduced or eliminated, the competitive nature of the industry should eliminate the built in pricing factor for default or delay in payment. For those with credit indemnity insurance, a more secure payment system is likely to result in lower premium rates or a reduction in the sum insured with a consequent reduction in premiums.

⁴¹ Para 3.32 below. A consolidated trust account could be kept in prescribed circumstances: para 3.34 below.

⁴² The Andersen Report at 9 concluded from data collected by the New South Wales Royal Commission Into the Building Industry that "the combined impact of late payment and payment default...equals 2.84% of total subcontractor turnover".

3.17 A second concern with a trust scheme is that it is effective only to the extent that there is trust property available to meet the claims of beneficiaries:

"It does not guarantee payment where, for example, the contractor or subcontractor has underbid a job or where the right of set-off arises because of an incomplete or deficient job. In the situation of underbidding or of set-off, it is conceivable that a trust beneficiary will not be paid in full even though there has been no breach of trust anywhere in the chain. As long as a trustee pays all trust money he receives, he discharges his obligation even though his beneficiary is not paid in full."⁴³

A trust scheme might, however, deter underbidding or underquoting for two reasons. First, it would be a breach of trust for trust funds from one project to be used to meet financial obligations on another project. It would therefore no longer be desirable to underbid on one project to obtain a cash flow to meet payments on another project.⁴⁴ Secondly, if there were insufficient funds available in the trust to pay all beneficiaries, the funds would have to be distributed on a pro rata basis to the beneficiaries.⁴⁵ The head contractor would not be entitled to any of the trust fund. It therefore would not be in the head contractor's interest to underbid or underquote for a project. Contractors could, however, cover themselves for any shortfall by credit indemnity insurance. So far as set-off is concerned, the reduction of trust funds by a set-off or counterclaim will be limited because the Commission recommends below⁴⁶ that only a party to a project should be entitled to a set-off and that party should be a beneficiary of the trust to the extent of the sum the debtor is entitled to receive from the fund. If the fund were insolvent, the trust monies would be distributed on a pro rata basis amongst the beneficiaries. While this would discharge the trustee's obligations under the trust, it would not discharge its obligations under the contract and action could be taken to recover any outstanding sum under the contract.

3.18 A third concern is that one consequence of a trust scheme is that it will reduce the scope for contractors, particularly head contractors, to divert money received for one project to meet payments on another project. To the extent that this occurs at present, it will be necessary to secure other funds to meet the payments on other projects. A trust scheme will not completely deny a builder the opportunity of using funds due to him on one project on another project because a trustee will still be able to withdraw funds from the trust in some

⁴³ Ettinger 393.

⁴⁴ This was one undesirable practice referred to above: para 1.8.

⁴⁵ Para 3.47 below.

⁴⁶ Para 3.41.

circumstances, for instance, where the trust account balance exceeds the moneys owing to the beneficiaries of the trust.⁴⁷ In any case, the Commission considers it to be fair that funds cannot be diverted from one project to another. It is merely good business practice and good corporate governance to ensure that adequate funding is available for a project without recourse to funds properly due to another contractor on another project and without putting those funds at risk by using them on the project. It would also discourage individuals or corporations which are under capitalised from operating on the basis of "free" capital supplied by others lower in the contractual chain.

3.19 According to an opinion prepared for the New South Wales Security of Payment Committee the prevention of the diversion of funds from one project to another project was seen as a strength of the trust approach by the Australian Banking Association and the Australian Finance Conference. Both endorsed the trust approach on the basis that it would ensure that funds made available for a project actually went into the project thereby preserving the value of and enhancing the security taken by the financier over the project.

3.20 A fourth concern with a trust scheme is that those higher up the contractual chain may attempt to evade a trust scheme by adopting a residence or domicile or obtaining finance outside the State. However, the State Parliament can enact laws having extraterritorial operation,⁴⁸ that is, laws which affect persons, conduct or things outside the State, so long as the law has a sufficient connection with the State.⁴⁹ There might also be concern that a trust scheme would breach section 92 of the *Commonwealth Constitution* which provides that "trade, commerce, and intercourse among the States....shall be absolutely free". The Commission's position is that this is not the case because a trust scheme would not impose government controls or burdens which discriminate against interstate trade and commerce so as to protect intrastate trade against competition. Nor are government controls to resolve

⁴⁷ Para 3.35 below. See also paras 3.36-3.43 below.

⁴⁸ *Australia Act 1986* (Cth) s 2(1). This may be contrasted with the position in Canada where, prima facie, provincial statutes do not have extraterritorial operation: *Horsman Bros Holdings Ltd v Sigurdson* (1979) 104 DLR (3d) 458, 462.

⁴⁹ See generally 5 *Halsbury's Laws of Australia* [90-1215], R D Lumb *The Constitutions of the Australian States* 5th edn (St Lucia, Qld: Uni of Qld Press, 1991) 86-89; P H Lane *An Introduction to the Australian Constitutions* 6th edn (Sydney: Law Book Co, 1994) 209-210; and Peter Hanks *Constitutional Law in Australia* 2nd edn (Sydney: Butterworths, 1996) 216- 224.

If the recommendation for a trust scheme were adopted, the legislation could contain a provision dealing with the application of the rules for choice of law: see eg *Bills of Exchange Act 1909* (Cth) s 77. It might be desirable to provide that all matters relating to the trust, including the personal liability of the trustee to the beneficiaries and the duty of the trustee to account for its administration of the trust, be governed by the law of the forum, which in most cases is likely to be Western Australia.

problems, which are not designed to protect intrastate trade against interstate competition, invalid if they are "...appropriate and adapted to the resolution of those problems [and if] any burden imposed on interstate trade was incidental and not disproportionate to their achievement".⁵⁰

3.21 A fifth concern with a trust scheme is that third parties may become involved. This concern arises because the law of trusts provides powers relating to the tracing of funds. However, trust funds can be traced and recovered only if they come into the hands of a third party who is not a bona fide purchaser for value without notice of the breach of trust.⁵¹ Otherwise the beneficiary may recover the trust monies or any other property into which the money has been converted or obtain a charge on the trust money or its traceable product. As notice of the breach may be constructive those dealing with trustees in legitimate business dealings, such as banks which hold trust funds, need to confirm that payments from trust funds to them, for example to reduce an overdraft or under an assignment of accounts receivable, are in accordance with the trust. If they are, they are free from fund tracing actions by beneficiaries of the trust. Canadian cases suggest that if a bank is aware that a customer is a head contractor or subcontractor and funds deposited in its account are the proceeds of building contracts, the bank is taken to have notice that the relevant legislation impresses the funds with a trust to the extent that; there are unpaid beneficiaries.⁵² Where banks are aware that funds deposited with them are trust monies they can avoid being subject to tracing actions by ensuring that the beneficiaries have been paid before receiving payments from their customer.

3.22 A sixth concern with a trust scheme is that it interferes with the application of the insolvency laws and the priorities for the distribution of a debtor's assets to its creditors because trust funds payable to participants in a project do not form part of the debtor's estate for distribution to the debtor's creditors. However, this interference can be justified because if it were not the case, creditors other than participants in the project would obtain a benefit from the work and materials supplied by the participants for which they had not been paid. Where the insolvent debtor is the owner of the building, the building will be an asset of the estate which can be used to satisfy the claims of its other creditors. Where the insolvent debtor

⁵⁰ *Castlemaine Tooheys Ltd v South Australia* (1990) 169 CLR 436, 473. See also *Cole v Whitfield* (1988) 165 CLR 360.

⁵¹ H A J Ford and W A Lee *Principles of the Law of Trusts* 3rd edn (Sydney: Law Book Co, 1996) para [17170].

⁵² Ettinger 422.

is one of the other participants in the project, any trust money paid to the debtor which it is entitled to retain for work done or materials it supplied will become an asset of its estate which can be used to satisfy the claims of its creditors.

(b) The trustee should not be a government body

3.23 In the Discussion Paper, the Commission raised the question whether or not a government body should be required to hold trust monies and distribute those monies to beneficiaries of the trust. In comments on the Queensland Government DP, BISCOA (Qld) favoured a single statutory trust for cash retentions held by a government body and funded from interest earned on the moneys held in trust.⁵³ It considered that this approach had a number of advantages including that there would be -

- * no question of the funds being misappropriated; and
- * fewer spurious disputes than if the funds were held by the builder.

The Commission does not favour this approach because it is likely to be expensive and create a large bureaucracy.⁵⁴ Accordingly, the Commission **recommends** that the responsibility of being the trustee should not be given to a government body but that the trustee should be permitted to be one of the participants in the construction project.⁵⁵

(c) A trust should attach to funds in the owner's hands

3.24 To provide maximum protection for the head contractor and others involved with a project, where the owner provides its own capital, the Commission **recommends** that moneys in the hand... of the owner to pay for, or funds received by the owner or earmarked by the owner to pay for, the improvements should be held in trust for the benefit of the head contractor.⁵⁶

⁵³ BISCOA (Qld) 14-15.

⁵⁴ The use of a government body was rejected by the Smith Report in 1974 because it would be an "administrative nightmare": para 7.36.

⁵⁵ The trustee should be free to appoint a person, including a trustee corporation, to be the trustee in its place: *Trustees Act 1962* s 7(1). That trustee, no doubt, would need to be paid a fee and have its expenses reimbursed by the person who appointed it.

⁵⁶ This would include -

(a) any funds of the owner that he identifies to the head contractor as funds to be used for payment of the improvement, including rental income;

Bringing the trust into existence at the earliest possible time preserves the funds within the construction chain. If this did not occur the time at which the trust arises in relation to the head contractor would be crucial in some cases. This is generally when contract moneys are "received" by the contractor.⁵⁷ However, if this is the case, difficulties can arise during the period of time before the contractor obtains physical possession of the moneys. The owner might make a claim for set-off against the contractor which exceeds the amount it owed the contractor. If this were the case, no sum would become payable to the contractor and no trust could come into existence.⁵⁸ If the trust does not arise until contract moneys are received by the contractor, an attachment order by a third party⁵⁹ served on the owner before the owner parts with the moneys can prevail over the trust.⁶⁰ On the other hand, moneys paid into court have been deemed to be impressed with a trust even though the contractor has not physically received them.⁶¹ The Commission's recommendation in this paragraph is also intended to avoid these difficulties.

3.25 Part or all of the funds to pay the head contractor under the contract might come, not from the owner's own resources, but from a financier and those funds might be secured by a mortgage or other security. In these circumstances, the Commission **recommends** that all amounts received by the owner or advanced by a financier⁶² that are to be used in financing the improvement should be held in trust for the benefit of the head contractor.⁶³ That is, a trust

-
- (b) any funds received by one owner from another owner that are to be used as payment for the improvement;
 - (c) where the owner's interest in the improvement is sold before the full sum due to the head contractor has been paid, a portion of the proceeds of the sale equal to the sum outstanding to the head contractor.

As is the case in Saskatchewan, it may be necessary to provide that where the consideration in a contract does not consist of money, the value of the part of the consideration that does not consist of money is deemed to be money for the benefit of the beneficiaries of the trust: Sask s 10. It may also be necessary to make express provision for the manner in which the proceeds of an insurance policy are to be distributed where an improvement is wholly or partly destroyed: see Sask s 9.

⁵⁷ In Canadian provinces where the statute creates a trust out of funds received by a contractor, "...successful attempts have been made....to create trusts of moneys in the hands of owners where none are specifically provided for in the Act." This has been done on the basis of constructive receipt on the ground that "...once moneys are actually owed, although not yet due and payable by an owner to a general contractor, the funds are constructively received by the contractor": Macklem and Bristow 9-5.

⁵⁸ Macklem and Bristow 9-33 and 9-34.

⁵⁹ Including one by the Commonwealth Commissioner of Taxation under s 218 of the *Income Tax Assessment Act 1936* (Cth); see *Deputy Commissioner of Taxation (Vic) v Ericksen* (1988) 19 ATR 1027 and *Elric Ply Ltd v Taylor* (1988) 19 ATR 1551.

⁶⁰ Macklem and Bristow 9-21. There is now a statutory reversal of this result in Manitoba: footnote 114 below.

⁶¹ Macklem and Bristow 9-22.

⁶² Usually funds are advanced directly to the head contractor by the financier as each progress payment falls due.

⁶³ See Sask s 6(1).

would arise in relation to the funds at the time the financier is required to advance the funds to enable the owner to meet a progress payment or final payment to the head contractor. This recommendation is also intended to avoid the difficulties referred to in the previous paragraph. Where an owner is a trustee of funds in the manner recommended in this and the previous paragraph, the owner should not appropriate or convert any part of the trust monies to its own use or to any use inconsistent with the trust until the head contractor is paid all amounts related to the improvements payable to it under the contract.⁶⁴

3.26 In the Discussion Paper, the Commission suggested that it might be considered to be overly onerous to require an owner building his own home to act as a trustee and take responsibility for the disbursement of funds.⁶⁵ He could, of course, appoint a trustee in his place but he might have to pay the trustee's fees and expenses. However, in view of the Commission's recommendation in the following section that each participant in a project should be a trustee of funds on account of the contract, the obligation to act as a trustee would not be onerous. Accordingly, the Commission **recommends** that an owner building his own home should be subject to the fiduciary duty to hold moneys on account of the contract for the benefit of the head contractor. He would discharge this duty simply by making the ordinary progress payments to the builder or by making payments to his tradesmen or suppliers if he did not employ a builder. Once these payments were made, the recipient would be the trustee in relation to payments due to its subcontractors, employees and suppliers of materials and services.

(d) Each participant who is under an obligation to another participant of a project should be a trustee

3.27 Having recommended that the trustee should be one of the participants in the construction project, rather than a government body, the question arises whether there should be a single trustee for a project or whether each participant in a project who is under an obligation to pay another participant should be a trustee. The first approach has been proposed in New South Wales where it was suggested that the head contractor should be the trustee.

In Ontario all amounts received by an owner that are to be used in the financing of the project constitute a trust fund for the benefit of the head contractor; Ont s 7(1). A similar trust arises where an amount becomes payable by the owner on a certificate of payment (Ont s 7(2)) or where substantial performance of a contract has been certified: Ont s 7(3). See also Man s 5(1)-(2).

In Ontario the owner discharges its obligations under the trust when it pays to the contractor the amount certified for payment: Ont s 10.

⁶⁴

See Sask s 6(4).

⁶⁵

The trust legislation in Ontario does not apply to a "home buyer": Ont s 7(1).

The NSW Issues Paper suggested that legislation should be enacted to make mandatory trust clauses in favour of subcontractors:⁶⁶

"The trust clause would be inserted in every subcontractor contract and would be to the effect that the main contractor hold all monies received from the owner in respect of subcontractor work in the trust for the subcontractor. The definition of 'subcontractor' should be wider than currently generally accepted by industry and cover all who are not in direct contractual nexus with the project owners for example, professionals who provide service to the main contractor rather than as a principal in contract with the owner."⁶⁷

Under this approach, the trustee, whether the owner or head contractor, holds the project funds in trust for all those who contribute to the project even if there is no privity of contract with the owner or the head contractor. The trustee would pay all those involved with the project out of the trust moneys. If the head contractor were the only trustee, it would pay subcontractors out of the trust money and when they had been paid all moneys due, the balance could be transferred to the contractor's own account. The second approach has been adopted in a number of Canadian Provinces.⁶⁸ Under this approach, each participant in the construction project who holds or receives a payment on account of the contract and is under an obligation to pay another participant holds those moneys as a trustee. Generally, the head contractor and subcontractors would make payments from the trust monies to their subcontractors and could transfer the balance to their account once their obligations had been met.⁶⁹ As the second approach is potentially simpler to administer than the first approach, because a trustee can fully discharge its obligations by paying in full the parties with which it has contracted, the Commission **recommends** that it be adopted.

(e) The "privity of trust" approach should not be adopted

3.28 In some Canadian provinces each trustee is required to hold funds in trust only for those with which it has contracted directly (known as the "privity of trust" approach).⁷⁰ In

⁶⁶ The trust would be reinforced by substantial pecuniary penalties. Compliance with the legislation would be supervised by the NSW Building Services Corporation, which could prosecute head contractors for breaches of the legislation.

⁶⁷ Para 9.9.

⁶⁸ See, for example, Alta s 16; BC s 2(1); Man s 4(1)-(2) and Ont s 8.

⁶⁹ For other circumstances in which the trustee might obtain money from the trust fund see paras 3.35-3.43 below.

⁷⁰ This approach has been adopted in Alberta, Manitoba, Saskatchewan and Ontario. In Manitoba, for example, s 4 of the *Builders' Liens Act RSM 1987 c B91* provides:

"Receipts of contractor constitute trust fund

other provinces each trustee is required to hold funds for all those down the chain from it.⁷¹ The Commission **recommends** that the second of these approaches be adopted because it has the advantage that those further down the chain have greater protection. They can obtain trust money directly when there is a problem with a contractor higher in the chain or they can attempt to prevent a breach of trust. It is true that the first approach, the privity of trust approach, has two advantages -

1. It is simple. The trustee knows that the beneficiaries are those with which it has contractual privity.
2. It maintains an orderly flow of funds down the chain.⁷²

However, its main disadvantage, which outweighs these advantages, is that it is rigid:

"...in that a sub-subcontractor or supplier way down the chain has limited ability to bring an action to enforce a trust further up the chain or attach moneys further up the chain. Instead the sub-subcontractor or supplier must wait for funds to 'trickle down'.

-
- (1) All sums....received by a contractor on account of a contract price constitute a trust fund for the benefit of
 - (a) sub-contractors who have sub-contracted with the contractor and other persons who have supplied materials or provided services to the contractor for the purpose of performing the contract;
 - (b) the Workers' Compensation Board;
 - (c) workers who have been employed by the contractor for the purpose of performing the contract; and
 - (d) the owner for any set-off or counterclaim relating to the performance of the contract.

Receipts of sub-contractor constitute trust fund

- (2) All sums...received by a sub-contractor on account of a contract price in the sub-contract, constitute a trust fund for the benefit of
 - (a) sub-contractors who have sub-contracted with the sub-contractor and other persons who have supplied materials or provided services to the sub-contractor for the purpose of performing the sub-contract;
 - (b) the Workers' Compensation Board;
 - (c) workers who have been employed by the sub-contractor for the purpose of performing the sub-contract; and
 - (d) the contractor or any sub-contractor for any set-off or counterclaim relating to the performance of the sub-contract."

⁷¹ This approach has been adopted in New Brunswick and British Columbia. In British Columbia, for example, s 2(1) and (2) of the *Builders Lien Act RSBC 1996 c 41* provide:

- " (1) All sums received by a contractor or subcontractor on account of the contract price are and constitute a trust fund in the hands of the contractor or of the subcontractor, as the case may be, for the benefit of the owner, contractor, subcontractor, Workers' Compensation Board, workers and material suppliers.
- (2) The contractor or the subcontractor, as the case may be, is the trustee of all those sums received by the contractor or subcontractor on account of the contract price, and, until all workers and all material suppliers and all subcontractors are paid for work done or material supplied on the contract and the Workers' Compensation Board is paid any assessment with respect to those sums, must not appropriate or convert any part of it to the contractor's or subcontractor's own use, or to any use not authorized by the trust."

⁷² Ettinger 416.

If a link in the chain is bankrupt or insolvent before receiving trust funds, those further down must wait for a trustee in bankruptcy or receiver to be appointed and then run the risk of having to fight with the trustee in bankruptcy or receiver over what funds are subject to the trust. Also, in the event a link in the chain fails to take action to enforce the trust of which he is a beneficiary, others down the chain may face difficulties in bringing an action to enforce a trust of which they are not direct beneficiaries. Either they may not be permitted to enforce a trust of which they are not beneficiaries or the court may find itself standing on its head and straining the facts in order to find privity of contract where none really exists."⁷³

A link in the chain might be broken, for example, if a bankrupt contractor assigned its interest in its contract with the owner to the contractor's trustee in bankruptcy.⁷⁴ Under the privity of trust approach, this assignment would be subject to the trust in favour of the contractor's subcontractors but not, for example, that subcontractor's suppliers. Once the subcontractor was entitled to funds from the contractor's trustee in bankruptcy those funds would be subject to a trust in favour of the subcontractor's suppliers.

3.29 If, as recommended by the Commission, more than one participant in the construction project is required to act as a trustee, two issues need to be addressed. The first is whether moneys received by one subcontractor should be held in trust for those in the chain below another subcontractor. If the moneys received by one subcontractor were trust funds for those claiming under other subcontractors it would be difficult to identify all the beneficiaries. In Canada the problem of identifying beneficiaries has been dealt with by holding that a claimant:

"...cannot claim against moneys received by a collateral subcontractor who has received moneys from the head contractor for to do so would result in the workmen, materialmen and subcontractors of that collateral subcontractor being denied payment of moneys which are properly theirs. To put it perhaps in a colloquial way the claims....may be made vertically but not laterally."⁷⁵

The Commission **recommends** that this approach be adopted in Western Australia.

⁷³ Ibid.

⁷⁴ By a deed of arrangement under Part X of the *Bankruptcy Act 1966*. This might be done to frustrate attempts by the Commissioner of Taxation to recover moneys due or accruing or which may become due to a taxpayer by an attachment of the moneys under s 218 of the *Income Tax Assessment Act 1936*: see *Re Kerrisk; Ex parte Duus (as trustee for Kerrisk)* (1993) 93 ATC 4190.

⁷⁵ *Cronkhite Supply Ltd v Workers' Compensation Board et al; Fidelity Insurance Co of Canada, Third Party* (1978) 91 DLR (3d) 423, 432.

3.30 The second issue is what should the trustee be required to do to discharge its obligations to the beneficiaries. In Canada, a trustee's obligations to the beneficiaries are fully discharged when the trustee has paid in full the parties with whom it contracted.⁷⁶ This means, for example, that an unpaid supplier of a subcontractor is not entitled to be paid from any contract moneys in the hands of the head contractor if the head contractor has already paid the subcontractor all moneys due and owing to it. When the trust is insolvent, the trustee can discharge its obligations to the beneficiaries by distributing the funds on a pro rata basis.⁷⁷

The Commission **recommends** that this approach be adopted in Western Australia.

3.31 Irrespective of the approach adopted, it is important that the legislation define clearly those who may be a beneficiary of the trust.⁷⁸ If this is not done, some participants in a project may be excluded. For example, in the absence of an express statutory provision, it has been held in Canada that a person who merely rents equipment to be used on a project is not a beneficiary of the trust.⁷⁹

(f) The trustee should be required to keep a separate trust account

3.32 To promote the effectiveness of a trust scheme, the Commission **recommends** that a trustee, including an owner building his own home, should be required to keep trust funds in a trust account,⁸⁰ separate from its general banking account.⁸¹ Otherwise, the trust funds could

⁷⁶ See Ettinger 412.

⁷⁷ Para 3.47 below.

⁷⁸ See generally Macklem and Bristow 9-12.1 to 9-21.

⁷⁹ Macklem and Bristow 9-13. It has now been expressly provided in all provinces that these suppliers are beneficiaries of the various trust funds: *ibid*.

⁸⁰ In a number of cases in England dealing with a trust for retention moneys under standard form contracts it has been held -

1. As the contractor was to be treated as a fiduciary in relation to retention moneys, it was under a duty to set the retention moneys aside in a separate account: *Wates Construction (London) Ltd v Frantham Property Limited* (Unreported) referred to in F Fitzpatrick *Retention funds in building contracts* [1991] New LJ 1007, 1007. A mandatory order can be made by a court requiring the contractor to set aside as a separate trust fund a sum equal to that part of the sum certified in any interim certificate by an architect as being retention money: *Rayack Construction Ltd v Lampeter Meat Co Ltd* (1979) 12 BLR 34, 38.
2. In the case of a **solvent** contractor, the equitable maxim that equity looks on that as done which ought to be done can come to the aid of a subcontractor and the contractor is deemed to have held retention moneys on trust: *Re Arthur Sanders Limited* (1981) 17 BLR 125, 136.
3. The effect of **insolvency** is that if the fund has not been set aside, no injunction will be ordered to constitute it and the maxim of equity looking on that as done which ought to be done will not apply: *Re Jartay Developments Ltd* (1982) 22 BLR 134, 136.

⁸¹ To reduce the costs associated with keeping separate trust accounts, trust accounts could be made exempt from financial institutions duty and debits tax. Prescribed trust accounts required to be kept under a

become mixed with other money and therefore be unidentifiable. A requirement for a separate trust account will:

"...effectively eliminate a problem encountered in [Canadian Provinces] where a contractor pays trust money into his general account and his bank takes the money to cover the contractor's previous indebtedness to the bank. As long as the bank did not have notice, actual or constructive, that the funds were subject to a trust, the bank is entitled to the moneys."⁸²

3.33 It should also discourage practices such as paying past accounts or financing new projects with payments for a current project. This requirement may seem onerous to those contractors who rely on the ability to borrow funds using accounts receivable as collateral. However, as Ettinger points out:

"This is less of a problem than it appears for two reasons: 1) if the bank is lending money on the basis of accounts receivable, it is already taking into account the customer's accounts payable and basically the trust obligations are the accounts payable, and 2) if the money is lent for the purpose of paying trust beneficiaries, the customer is able to repay the bank from trust funds without committing a breach of trust."⁸³

(g) A trustee should (in certain circumstances) have the option of having a separate trust account for each project or a single consolidated trust account

3.34 Another question raised in the Discussion Paper was whether the trustee should be required to keep a consolidated trust account, that is, one account into which all trust moneys in respect of all projects should be paid, or a separate trust account for each project. In Canada it has been held that if accounts have been mingled, so that a number of subcontractors from different projects can trace moneys to that one mingled account, they are all on an equal footing and are entitled to payment out of the account rateably. If, however, the moneys are clearly identifiable and traceable to one of the projects, the recovered sum is deemed to be impressed with a trust in favour of the subcontractors of that project.⁸⁴ Clearly it is desirable

prescribed Act can, for example, be exempt from financial institutions duty: see *Financial Institutions Duty Act 1983* ss 15 and 10(4)(a).

⁸² Ettinger 398. Many cases in Canada deal with the question of whether or not the bank was aware of the nature of the funds. A statutory trust itself does not constitute notice of a trust: Macklem and Bristow 9-28. If a bank is aware that the funds are trust funds, the bank is a participant in a breach of trust which makes it liable to the beneficiaries. In any case, the trustee is in breach of the trust for failing to preserve trust assets. If the trustee is a corporation, its officers and directors who are its operating mind will be personally liable; id 9-52.

⁸³ Ettinger 428. As to the second point see para 3.37 below.

⁸⁴ Macklem and Bristow 9-15.

to ensure that moneys from different projects are not mingled. However, some contractors' accounting standards may not be adequate to ensure that funds can be identified as belonging to particular projects. To ensure that moneys from different projects are not mingled, the Commission **recommends** that trustees (whether an owner building his own home, a contractor or a subcontractor) should be required to open a separate trust account for each project. However, trustees should have the option of using a single consolidated trust account with the approval of the Builders' Registration Board if they can demonstrate that they can maintain books of account of all trust moneys received, deposited or disbursed in such a manner as to disclose the true position as regards those moneys in relation to particular projects and to enable the books to be readily and conveniently audited. If this option is taken, the account should be audited annually.

(h) Withdrawal of money from the trust fund by the trustee

3.35 An important issue with a trust scheme is determining when a trustee can draw funds owing to it from the trust fund. One option is to allow a trustee who is the head contractor or a subcontractor to withdraw the balance of the trust funds when the project is completed, so long as all obligations to its beneficiaries have been met.⁸⁵ However, while this option should be available, the Commission **recommends** that a trustee should be able to withdraw money from a trust fund before a project is completed so long as there is sufficient money left in the fund to pay the beneficiaries the moneys owing to them in full. This would enable the trustee to withdraw funds to meet its own overheads or profit. To provide otherwise could cause financial hardship to trustees, particularly on projects which extended over a long period of time.

3.36 In some circumstances the trustee might pay for materials, service, labour or rented equipment for the project out of its own funds. In these cases the Commission considers that it is fair to allow a withdrawal from the trust fund of an amount equal to the sum paid and **recommends** that such a withdrawal should not constitute a breach of trust so long as the fund is not insolvent or rendered insolvent as a result of the withdrawal.⁸⁶ Where a fund is

⁸⁵ In this case, the trustee would receive the balance of the fund including any interest which had accrued on the money held in trust.

⁸⁶ This is the case, for example, in Ontario: Ont s 11(1).

insolvent, the Commission recommends below that the moneys in the fund should be distributed to the beneficiaries on a pro rata basis.⁸⁷

3.37 In other cases a trustee might meet its obligations to the trust fund's beneficiaries out of borrowed money. For example, a contractor who wished to pay its subcontractors, but which had not received sufficient money from the owner at the time to do so, might obtain a loan or an overdraft facility from a financial institution to pay the subcontractors, the expectation being that the debt would be repaid once the owner eventually paid the contractor. In these circumstances it is reasonable that, once a payment of funds is received by the trustee from the owner, trust moneys should be used by the trustee to discharge the loan to the extent that the lender's money was used by the trustee to pay in whole or part for work done or materials incorporated in an improvement,⁸⁸ particularly as it does not reduce the funds flowing down the chain. Accordingly, the Commission **recommends** that a trustee should be able to withdraw moneys from a trust fund to discharge a loan to the extent that the lender's money was used by the trustee to pay in whole or part for work done or materials incorporated into an improvement. Once again this should only occur if the trust fund is not insolvent.

3.38 A final circumstance in which a trustee might be allowed to appropriate trust funds is where a beneficiary is liable to pay the trustee money for outstanding debts, claims or damages either-

- (i) unrelated to the project; or
- (ii) only when related to the project.⁸⁹

A trustee could be allowed to recoup moneys out of trust funds for any money due from the beneficiary to the trustee either in relation to the project or to any project.⁹⁰ Such a

⁸⁷ Para 3.47.

⁸⁸ S 11(2) of Ont provides, for example:

"Subject to Part IV, where a trustee pays in whole or in part for the supply of services or materials to an improvement out of money that is loaned to the trustee, trust funds may be applied to discharge the loan to the extent that the lender's money was so used by the trustee, and the application of trust money does not constitute a breach of trust."

See also Man s 6(1), which allows trust money to be applied to discharge a loan to the extent that the lender's money is used to meet obligations in relation to the project.

The trustee must actually elect to make repayment to the Lender, and the whole of the money so repaid must be used for the project to which the trust relates: Macklem and Bristow 9-31.

⁸⁹ In Ontario, the set-off may apply to debts, claims or damages whether or not related to the project: Ont s 12.

⁹⁰ For the position in a number of Canadian Provinces see Ettinger 405-406.

recoupment might, however, result in a deficiency in the trust fund, that is, it might not be possible to pay all the beneficiaries of the trust the sums due to them from the sum left in the fund after the recoupment. For example, if the trustee is the head contractor and the beneficiary is a subcontractor, the subcontractor may owe the head contractor liquidated damages calculated at a rate per week prescribed in their agreement if it has failed substantially to complete the subcontract works by the date provided in the contract.⁹¹ Recoupment of this sum will reduce the sum available to pay all the subcontractors and suppliers.

3.39 In Canada, in the absence of express statutory provision, it has been held that the trust imposed on the contractor attaches only to the net amount owed by the owner to the head contractor.⁹² The owner can retain the amount of any set-off or counterclaim and the net amount then becomes the corpus of the trust fund. However, this does not apply in those provinces where a trust attaches to funds in the hands of the owner. A number of provinces have express statutory provisions. In Ontario, for example, "...a trustee may, without being in breach of trust, retain from trust funds an amount that, as between the trustee and the person the trustee is liable to pay under a contract or subcontract related to the improvement, is equal to the balance in the trustee's favour of all outstanding debts, claims, or damages, whether or not related to the improvement."⁹³ There is a similar provision in Saskatchewan; but it is limited to all outstanding debts, claims, or damages related to the improvement.⁹⁴ In Manitoba, on the other hand, the owner is made a beneficiary of the head contractor's trust "for any set-off or counterclaim relating to the performance of the contract."⁹⁵ The head contractor is a beneficiary of the subcontractor's trust "for any set-off or counterclaim relating to the performance of the sub-contract" and so on down the chain. The trustee of the fund cannot appropriate or convert any part of the fund for its use until the beneficiaries and others are paid and "provision has been made for the payment of other affected beneficiaries of the trust to whom amounts are then owing out of the sum received."⁹⁶ Ettinger suggests that the approach in Manitoba was introduced to "...eliminate the possibility of trust beneficiaries

In Manitoba the owner discharges its obligations under the trust when it pays the contractor "all sums justly owed to him in respect of the performance of the contract"; but it is required to see that "provision for the payment of other affected beneficiaries of the trust has been made": Man 5(3).

⁹¹ See eg SC.JCCA 1985 cl 10.15.

⁹² Ettinger 406. For a similar conclusion in Australia see *Mitchell v Purnell Motors Pty Ltd* [1961] NSW 165.

⁹³ Ont s 12.

⁹⁴ Sask s 13.

⁹⁵ Man s 4(1)(d).

⁹⁶ Man ss 4(3)(d) and (4)(d).

claiming priority over the right to set-off on the basis that the trust corpus was established prior to the right of counterclaim arising.¹⁹⁷

3.40 A right to recoup moneys from the trust fund for a set-off or counterclaim goes beyond allowing a trustee to reimburse itself from trust funds for sums paid out of its own funds or to repay a lender when the borrowed funds were used to pay trust beneficiaries. Reimbursement does not reduce funds flowing down the chain. Recoupment, particularly for set-off or counterclaims relating to other projects, is likely to result in a reduction in funds flowing down the chain. This could occur even if recoupment were confined to a set-off or counterclaim related to the project for which the trust fund was created. If a contractor or subcontractor abandoned a contract relating to the project, the costs of completing the project or damages resulting from delayed completion might increase the cost of the project to the owner. A recoupment by the owner from the head contractor of any increased costs would reduce the funds flowing down the construction chain.

3.41 The Commission does not favour the approach adopted in Ontario where the recoupment applies to sums whether or not related to the improvement. This is because it is inconsistent with the purpose of the trust scheme, to ensure that trust funds are used to pay participants in a project for their contribution to the project. The Commission considers that the fairest approach is one based on that in Manitoba where the owner is a beneficiary of the head contractor's trust for any set-off or counterclaim relating to the performance of the contract and has the same ranking as other beneficiaries of the trust. However, the Commission considers that the sum which can be paid to the owner for a set-off or counterclaim from the trust fund should not have the effect of reducing the sum available for distribution to the other beneficiaries of the trust. That is, the sum available to meet the owner's set-off or counterclaim against the head contractor as a beneficiary of the trust should be confined to the sum that the head contractor is entitled to receive from the trust after the payment of the other beneficiaries of the trust such as the head contractor's subcontractors and suppliers.⁹⁸ The Commission **recommends** accordingly.

3.42 The operation of this recommendation is illustrated by the following example. Suppose the owner, O, is under an obligation to pay the head contractor, HC, \$100,000 on account of the contract price and HC is under an obligation to pay \$90,000 to its

⁹⁷ Ettinger 405.

⁹⁸ And so on down the chain.

subcontractors. The balance, \$10,000, can be appropriated by HC once its subcontractors are paid the money owed to them from the trust fund. If O is entitled to a set-off or counterclaim of \$4,000 against HC this sum can be paid from the sum of \$10,000 which HC is entitled to receive from the trust fund. HC then receives the balance of \$6,000. If the set-off or counterclaim were \$12,000 only \$10,000 could be recovered by O from the trust fund. The balance of \$2,000 would have to be recovered in an action against HC. O can protect itself against any loss it might suffer by obtaining insurance to cover the loss⁹⁹ or by requiring HC to provide a payment bond. If the trust fund is insolvent, that is, there are insufficient funds to meet the sums due to all the beneficiaries, the head contractor will not be entitled to receive any money from the fund because all the money in the fund will be distributed to the fund's beneficiaries on a pro rata basis.¹⁰⁰ In this case, there will be no sum against which the owner's set-off or counterclaim can be paid. This approach allocates risk to the party best placed to assess it and to take steps to obtain protection against any financial loss that that party might suffer. In the example given above, the owner, who was responsible for selecting the head contractor, is the party best placed to assess the head contractor's financial, managerial and technical capacity or ability and to take steps to obtain protection against any risk of financial loss that that assessment discloses.

3.43 In some cases a trust fund might be insolvent because O has not paid HC the total sum due to it.¹⁰¹ Suppose HC is under an obligation to pay \$90,000 to its subcontractors but due, for example, to the insolvency of O, it has received only \$80,000 from O. In this case the trust fund of \$80,000 would be distributed amongst the beneficiaries on a pro rata basis.¹⁰² HC could not withdraw any sum from the fund. However, if HC were entitled to a set-off or counterclaim against one of its subcontractors it would be a beneficiary of the trust but only to the extent of the sum that that subcontractor was entitled to receive from the pro rata distribution of the trust and after payment of its subcontractors and suppliers.

3.44 Adoption of the recommendation in this section would not prevent the creation of retention funds so long as they are trust funds.¹⁰³ These funds are created to enable head contractors and subcontractors to provide security to the amount or percentage set out in the contract for the due performance of their obligations under the contract.¹⁰⁴

⁹⁹ For example, as home builders must do at present.

¹⁰⁰ Para 3.47 below.

¹⁰¹ And so on down the chain.

¹⁰² Para 3.47 below.

¹⁰³ See the recommendation in para 3.91 below.

¹⁰⁴ See, eg, SC.JCC.A 1985 cls 10.21-10.26.

(i) Distribution of trust funds to the beneficiaries

3.45 The timing of payments by a trustee to the beneficiaries of the trust fund is important. If a trustee were required to maintain an even hand, it would not be possible to make progress payments to subcontractors in case the fund became insolvent. In Canada, a trustee is not required to maintain an even hand among the beneficiaries, at least where the claims of the beneficiaries do not exceed the amount available for distribution.¹⁰⁵ The reason for this is that:

"...contractors must be able to pay their subcontractors and suppliers as the work proceeds and not be in breach of the trust even if some beneficiaries end up not being paid in full. As long as the contractor has paid out all the trust funds to trust beneficiaries, he will have discharged his trust obligations. The alternative would be for the contractor to withhold payment from all beneficiaries until the end of construction when he could be sure of ascertaining all the beneficiaries and their pro rata portion. This would be a commercially unacceptable impediment to the flow of funds, and one would assume, contrary to the intent of the legislation."¹⁰⁶

In Canada it has been held that where trust funds are paid to a beneficiary of the trust, the beneficiary cannot apply the funds, the subject of a trust of which it has notice, to a purpose outside the trust such as to the payment of an earlier account relating to another project.¹⁰⁷ As the fund is being distributed on equitable principles, it would be inequitable to allow a beneficiary, having received a payment from the trust fund, to apply it on an earlier project's account, and then to claim against the fund, without giving credit for that payment.¹⁰⁸

3.46 The Commission considers that the rules in Canada relating to the timing of the payment to beneficiaries of the trust should be adopted in Western Australia. This is because otherwise there would be a significant departure from the existing practice which usually involves progress payments being made as a project proceeds to completion, and not a single payment when a project is completed or when a subcontractor completes its work. Accordingly, the Commission **recommends** that, where a trust fund is solvent, the trustee should be allowed to make payments to beneficiaries of the trust as they fall due.

¹⁰⁵ See Ettinger 403-405 and Ont s 10.

¹⁰⁶ Ettinger 404.

¹⁰⁷ *Standard Prestressed Structures Ltd v Bank of Montreal* (1968) 69 DLR (2d) 183, 193-194.

¹⁰⁸ Id 194.

(j) Distribution of trust funds to the beneficiaries if the trust fund is insolvent

3.47 Cases may arise in which the trust fund is insolvent¹⁰⁹ so that there are insufficient funds to satisfy the claims of all the beneficiaries of the trust. In these cases, the Commission considers that the fairest approach is to require that the trust funds be distributed amongst the trust's beneficiaries on a pro rata basis. It **recommends** accordingly. This recommendation is consistent with rules of equity under which impartiality between the beneficiaries is the guiding principle.¹¹⁰ It is a logical, just and workable rule.¹¹¹ Such a distribution would not relieve the trustee of liability to a beneficiary for the balance of the outstanding claim.

(k) Priority as between trust beneficiaries and a judgment creditor who has obtained an attachment order

3.48 If the Commission's recommendation that the owner should be a trustee of funds for a project is not adopted, debts owing or accruing from the owner to a defendant (such as a head contractor) against whom any person has obtained a judgment or order for the recovery or payment of money could be attached to meet the judgment or order.¹¹² If the trust did not come into being until the contract money for a project were received by the contractor¹¹³ from the owner, the effect of the attachment order might be that the money would never actually be received by the contractor. To the extent that the money owing or accruing from the owner to the head contractor was attached to meet the judgment or order against the head contractor, the trust would not apply to the money. It would frustrate the policy of a trust scheme to give a judgment creditor a right against the garnishee (the owner) which it would not have against the head contractor which was indebted to it. It is fairer, if the head contractor's right to the disposal of contract moneys is subject to a trust, for a judgment creditor's right to those moneys also to be subject to the trust.¹¹⁴ For these reasons, the Commission **recommends** that

¹⁰⁹ See *Guarantee Trust Co of Canada v Beaumont* [1967] 1 OR 479 (CA) referred to in Macklem and Bristow 9-57-9.58 in which it was held that a trust fund must be distributed rateably ". . .once the builder had abandoned the project...because, although he had not been formally declared a bankrupt, he was in fact insolvent."

¹¹⁰ R P Meagher and W M C Gummow *Jacobs' Law of Trusts in Australia* 6th edn (Sydney: Butterworths, 1997) para 1901. See also Ettinger 404.

¹¹¹ Unlike the Clayton's case rule, which allocates funds in an account on a "first in - first out" basis: see *Re Eastern Capital Futures Ltd (in liquidation)* [1989] BCLC 371 and *Re Ontario Securities Commission and Greymac Credit Corporation* (1986) 30 DLR (4th) 1.

¹¹² *Supreme Court Act 1935* s 126(1); *Local Courts Act 1904* s 145.

¹¹³ Or others in privity of contract with the owner or a nominated subcontractor.

¹¹⁴ In Manitoba, for example, trust money is protected from attachment. Man s 6(2) provides: "Where money owing to a contractor or sub-contractor in respect of the contract price under a contract or sub-contract would, if paid to the contractor or sub-contractor, be subject to a trust..., the money is not subject to garnishment under *The Garnishment Act*."

where money owing to a contractor on account of the contract price for a project would, if paid to the contractor, be subject to a trust, the money should not be subject to attachment. The attachment order should instead apply to the money the trustee is entitled to receive from the trust once its obligations to beneficiaries of the trust have been satisfied.¹¹⁵

(I) Priority as between trust beneficiaries and an assignee of an account

3.49 One practice at present is for a contractor¹¹⁶ who borrows money or has a line of credit with a supplier to make an assignment of present or future accounts as security for the loan or line of credit. This practice will need to be altered should provision be made for the trust scheme recommended by the Commission in this report. In a Canadian province with legislation which provides that all sums received by a contractor on account of the contract price are and constitute a trust fund in the hands of the contractor for the benefit of a subcontractor, it has been held that the term "received" includes money paid to an assignee of the contractor:

"The money 'received' on account of the contract is the same as that paid by the contractor: payment is the correlative of receipt. The assignee acts through the right and power of the assignor; and the receipt by him is likewise that by the creditor. If this were not so, the entire purpose of the section could be nullified by an assignment contemporaneous with the contract. ...The assignee of such moneys must either see to the satisfaction of the rights under the trust, either directly or by way of subrogation to them, or run the peril of participating in a breach of it."¹¹⁷

Some Canadian provinces have expressly provided statutorily that an assignment is subject to the trust.¹¹⁸

3.50 This position is consistent with the ordinary rules of equity. Under one of these rules:

"The assignee of an equitable interest, even for valuable consideration, takes subject to all equities and infirmities of his assignor's title."¹¹⁹

¹¹⁵ See para 3.35 above.

¹¹⁶ Or one of the others in the contractual chain.

¹¹⁷ *Minneapolis-Honeywell Regulator Co Ltd v Empire Brass Mfg Co Ltd* [1955] 3 DLR 561, 563. See also *A & M Painting Contractors Ltd v Byers Construction Western Ltd* (1981) 122 DLR (3d) 355, 363-366.

¹¹⁸ In Manitoba no assignment by a contractor or subcontractor of any moneys due or to become due on account of the contract price is valid as against any trust created under the Act: Man s 6(3). Where a right to payment of moneys which are subject to a trust is assigned, the moneys received by the assignee are subject to the trust and the assignee is the trustee: Man s 6(4).
See also Sask s 15.

¹¹⁹ *Redman v Permanent Trustee Co of NSW* (1916) 22 CLR 84, 91.

Even if a contractor purported to assign all of the funds he received on account of the contract funds, because they are trust funds, the assignee would take the money subject to any trust which would attach to those moneys in the hands of the assignor. Neither the assignor nor the assignee has any power to pay or appropriate money except for the purposes of the trust.¹²⁰ In Canada it has been held, however, that a participant in a building project's right to a share in a trust fund and rights of enforcement can be assigned.¹²¹ In these circumstances, if the Commission's recommendations were implemented, the existing practice could be altered so that the contractor or a beneficiary would assign to a creditor its right to a share in the trust fund and its rights of enforcement.

(m) Information and training as to trust obligations

3.51 For a trust scheme to be effective, it is important that those responsible for handling trust funds have at least a basic knowledge and understanding of the obligations of a trustee. The Commission therefore **recommends** that a training course be developed dealing with the obligations and requirements for maintaining and operating a trust account. However, the Commission does not consider that it is necessary to provide that registration or retention of registration as a builder should be conditional on passing a test demonstrating an elementary understanding of trust obligations and requirements. Nor should others in the industry, such as subcontractors, who handle trust funds be required to pass a test before being able to operate in the industry. Instead, the operation of trust accounts should be monitored by the Builders' Registration Board.¹²²

(n) No special limitation period should be provided for the enforcement of the trust scheme

Under the existing law no specific limitation periods apply to actions against trustees: the appropriate limitation period is that which would have applied if the defendant had not been a trustee.¹²³ As the scheme would confer a special privilege, the Commission considered whether or not those who benefit from the scheme should be required to make a claim

¹²⁰ *Standard Prestressed Structures Ltd v Bank of Montreal* (1968) 69 DLR (2d) 183, 193.

¹²¹ *Groves-Raffin Construction Ltd v Bank of Nova Scotia* (1975) 64 DLR (3d) 78, 105.

¹²² See para 3.55 below.

¹²³ *Limitation Act 1935* s 47. See Law Reform Commission of Western Australia Report on *Limitation and Notice of Actions* (Project No 36 Part II 1997) paras 13.11 and 13.24-13.30 and the discussion of the effect of fraud at paras 13.49-13.50.

promptly.¹²⁴ A special limitation period might also be justified because, unlike other types of trust, a breach is likely to be discovered quickly. If a beneficiary is not paid under the trust he will be aware of the breach within a short period of time. In its report, *Limitation and Notice of Actions*, the Commission recommended that its general principles should apply to equitable claims save for a few areas where special rules should be preserved.¹²⁵ It did so for the following reasons:

- "(1) For the full benefits of the reforms proposed by the Commission to be realised, the two general limitation periods recommended by the Commission have to apply to all types of claim, including equitable claims.
- (2) The examination of developments in the major areas of equitable jurisdiction undertaken in this chapter shows that the law has already proceeded a long way towards the desired goal."¹²⁶

However, the Commission recommended that where there is a claim in equity requesting an equitable remedy, a court should be able to deny the plaintiff the remedy sought on the grounds of laches or acquiescence, even though the appointed limitation period has not expired, because that would retain "important equitable doctrines without prejudicing the general scheme".¹²⁷ Consistent with that recommendation, the Commission **recommends** that no special limitation period should be provided for actions relating to the trust scheme recommended by the Commission in this report.

(o) **Disputes relating to the trust**

3.53 At present, any person who has an interest in any trust property and is aggrieved by any act, omission or decision of a trustee in the exercise of any power conferred by the *Trustees Act 1962* may apply to the Supreme Court to review the act, omission or decision or to give directions in respect of any apprehended act, omission or decision.¹²⁸ The Commission **recommends** that, should provision be made for the trust scheme recommended in this report, a similar power should be provided to allow disputes relating to the trust to be dealt with by

¹²⁴ A limitation period of 12 months was recommended in the Newfoundland Report: 103-106. The limitation period in Saskatchewan is 12 months: Sask s19(1). In Manitoba, a short limitation period is provided of only 180 days after the date upon which the person bringing the action first became aware of the breach of trust: Man s 8. There is no special limitation period in Ontario or British Columbia.

¹²⁵ Law Reform Commission of Western Australia Report on *Limitation and Notice of Actions* (Project No 36 Part II 1997) para 13.62.

¹²⁶ Ibid.

¹²⁷ Id paras 13.76 and 13.78.

¹²⁸ *Trustees Act 1962* s 94(1).

the Supreme Court. This would supplement the right any person dissatisfied with the conduct of a trustee has to apply to the Supreme Court for the appointment of a new trustee.¹²⁹ On such an application, the Court may make an order appointing a new trustee in substitution for a trustee who "has ...misconducted himself in the administration of the trust".¹³⁰ The Court also has power to appoint a receiver of trust property "where that is necessary for the well-being of the trust."¹³¹

(p) Measures to promote the effectiveness of a trust scheme

3.54 The Commission considers that a number of other measures should be taken to promote the effectiveness of the trust scheme recommended in this report. First, the Commission **recommends** that failure to comply with a trust scheme should be a ground for disciplinary action against a builder. To ensure that individuals cannot hide behind the veil of a partnership, company or other body corporate, if the registration of a partnership or a company or other body corporate is revoked, a finding should be made as to which individuals associated with the partnership or corporate body were responsible for the failure to comply with the trust scheme. If they are registered under the *Builders' Registration Act 1939*, that registration should be revoked as should the registration of any other partnership, company or other body corporate of which they are a partner, director or member of the board of management.

3.55 Secondly, the Commission **recommends** that the Builders' Registration Board should be given power to appoint and authorize an accountant who is registered as an auditor to examine the books of account and records relating to any trust account of a participant in the industry and to furnish the Board with a confidential report on the matter and things disclosed by the examination.¹³² The Board should use the power to carry out random checks or to carry out checks where it has reason to suspect a breach of trust. Where a breach of trust is uncovered, the beneficiaries of the trust should be advised of the breach so that they are in a position to take action to remedy the breach under either the existing law¹³³ or under the remedy recommended in the following paragraph.

¹²⁹ Id s 77(1).

¹³⁰ Id s 77(2)(b).

¹³¹ H A J Ford and W A Lee *Principles of the Law of Trusts* 3rd edn (Sydney, Law Book Co: 1996) para [17410].

¹³² See for example *Legal Practitioners Act 1893* s 38(1).

¹³³ See footnote 40 above.

3.56 Thirdly, the Commission **recommends** that where a trustee is a corporation or other body corporate, every director, officer, employee, agent or other person having effective control of the corporation or body corporate and who is responsible for a breach of trust¹³⁴ should be liable for the breach. Otherwise the "corporate veil" could be used to protect those who are personally responsible for a breach of trust from liability for the breach. In Australia there is a precedent for imposing a statutory duty on individual directors in the Corporations Law. For example, a director has a duty to prevent insolvent trading by his company.¹³⁵ If a director does not perform that duty, there are civil and criminal consequences for contravening it. A director is liable if he is aware that there are reasonable grounds for suspecting that the company is insolvent or would become insolvent by incurring debts or a reasonable person in a like position in a company in the company's circumstances would be so aware.¹³⁶ A number of defences are available including -

1. That the director, because of illness or for some other good reason, did not take part at the time when the debt was incurred in the management of the company.¹³⁷
2. That the director took all reasonable steps to prevent the company from incurring the debt.¹³⁸

3.57 In two Canadian provinces there are express provisions which make directors and officers of corporations liable for breaches of trust. In these provinces this is done by providing that:

"In addition to the persons who are otherwise liable in an action for breach of trust under this Part,

- (a) every director or officer of a corporation; and
- (b) any person, including an employee or agent of the corporation, who has effective control of a corporation or its relevant activities,¹³⁹

¹³⁴ For a detailed discussion of the personal and proprietary remedies for a breach of trust see H A J Ford and W A Lee *Principles of the Law of Trusts* 3rd edn (Sydney: Law Book Co, 1996) paras [17120]-[17340].

¹³⁵ *Corporations Law* (Cth) s 588G.

¹³⁶ Id s 588G(1) and (2).

¹³⁷ Id s 588H(4).

¹³⁸ Id s 588H(5). See generally B Mescher *Personal Liability of Company Directors for Company Debts* (1996) 70 ALJ 837.

who assents to, or acquiesces in, conduct that he or she knows or reasonably ought to know amounts to breach of trust by the corporation is liable for the breach of trust."¹⁴⁰

The Commission considers that this provision provides a satisfactory precedent for a provision to be enacted in this State.

3.58 The above measures would supplement the Criminal Code, which provides that it is a crime for any person, with intent to defraud, by deceit or any fraudulent means to cause a detriment, pecuniary or otherwise, to any person.¹⁴¹

In Canada, two of the provinces have special offences relating to building industry trusts which provide that it is an offence for every person upon whom a trust is imposed to appropriate or convert any part of any trust moneys to his own use or any use not authorised by the trust.¹⁴²

4. PAYMENT BONDING

(a) General

3.59 Under a payment bonding scheme, an owner or a head contractor is required to obtain a bond from an insurance company or bank guaranteeing the payment of the contractor and all subcontractors and employees.¹⁴³ Payment bonding is used in many States of the United States of America. Its purpose may be to provide protection for those higher up in the

¹³⁹ This is a question of fact and in determining it the court may disregard the form of any transaction and the separate corporate existence of any participant: Ont s 13(2) and Sask s 16(2).

¹⁴⁰ Ont s 13(1) and Sask s 16(1). See the Newfoundland Report; 96-97 and Macklem and Bristow 9-52. Those liable for a breach of trust are jointly and severally liable (Ont s 13(3) and Sask s 16(3)) and a person who is liable is entitled to recover contribution from any other person also liable for the breach: Ont s 13(4) and Sask s 16(4)

¹⁴¹ S 409(1)(d). Until 1990 s 417 of the *Criminal Code* contained an offence relating to a trustee fraudulently disposing of trust property. That section was repealed by s 25 of the *Criminal Law Amendment Act 1990* following a recommendation by M J Murray (as he then was) in the report *The Criminal Code: A General Review* (1983) Vol 1 275 because it was not required:

"To the extent that the activities proscribed by the Section do not constitute stealing of the trust property I am sure that the fraudulent activities of the trustee will be covered by the recommended section 409."

The existing s 409 of the *Criminal Code* is substantially based on that recommended section.

S 417 provided that it was a crime for a trustee, with intent to defraud, to convert the trust property to any use not authorized by the trust. Such an offence was necessary because at common law "a trustee could not steal trust funds because the property in the funds was in him": *Orsi v Legal Contribution Trust* [1976] WAR 74, 78.

¹⁴² See, eg, BC s 2(3); Man s 7.

¹⁴³ That is for work and materials supplied, not damages for loss of a contract or other more remote losses.

contractual chain, because suppliers, subcontractors and employees have a right to place a lien over the land involved in a construction project. To avoid this, it is in the interests of owners to ensure that those with a right to a lien are paid by requiring head contractors and subcontractors to provide bonds for the payment of their creditors and employees. Payment bonds could, however, be used to protect the financial interests of subcontractors.

(b) Recommendations

(i) Use of a bond as an alternative to a trust scheme

3.60 In some areas of the industry, such as the home building industry which does not involve a tender process, it is unnecessary to require owners to provide bonds because generally finance for the project will be secured before a project proceeds and the head contractor can require that proof of the approval of the finance be provided before work commences.¹⁴⁴ For this reason, the Commission **recommends** that those building their own home should not be required to obtain a bond to protect head contractors.¹⁴⁵

3.61 Different considerations might apply to the relationship between a head contractor building a home and its subcontractors or in other areas of the industry, particularly where the head contractor is required to tender for a project. In these cases the head contractor and subcontractors may not be well placed to require proof that finance for a project has been secured before a project proceeds. Payment bonds have two major advantages -

1. They do not interfere with the way the parties wish to organize the building project or with the flow of cash down the pyramid to subcontractors.
2. They are simple to administer if there is one bond covering all those involved with the construction project.

¹⁴⁴ Such proof might be in the form of an undertaking by a financial institution that it will advance the funds for the project. If the funds are to come from the owner's own resources, proof can be sought of the existence of those funds, for example, in the form of bank statements.

¹⁴⁵ If payment bonding were introduced in the building and construction industry it would not be unique in Western Australia. Provision is made for bonds as security for payment of any amount which is or may become payable by a taxi driver to a taxi operator: *Taxi Act 1994* s 36.

In view of these advantages, the Commission **recommends** that payment bonds should be available as an alternative to the trust scheme.¹⁴⁶ That is, if an owner or contractor has obtained a payment bond to guarantee the payment of all its contractors, employees or suppliers of materials and services for a project, the trust scheme should not apply to those payments.

3.62 This approach has the advantage that not only does it provide security of payment but also it means that some of the disadvantages of making payment bonding compulsory do not need to be addressed. One disadvantage of a compulsory payment bonding scheme is that the premium may be substantial¹⁴⁷ and in addition the insurance company may demand an indemnity from the owner or head contractor secured by a charge over its assets. This may have the effect of driving smaller builders from the industry or excluding them from some parts of the industry. Those that did not have the money "up front" for the premium would also be prevented from undertaking projects. This approach also has the advantage that a surety would not have to bear the burden of guaranteeing all participants in the project but only those in privity of contract with the owner or contractor. The surety would not have to take into account the financial soundness of remote participants in the project whose existence was unknown to the surety when it issued the bond and over which the owner or contractor had no power of selection or control. As the Law Reform Commission of British Columbia pointed out, to require the surety to guarantee not only the debts of the owner or contractor but also others down the chain:

"....would make the degree of risk of the guarantor difficult to estimate, it would make it more difficult for a contractor to obtain a guarantee and it might result in the realization of the fear... that the bonding companies would, as to certain projects, exercise a power of veto over subcontractors. This is because the contractor would not merely be exercising his right to prefer subcontractors who can obtain bonding to those who cannot, but because the contractor might not himself be able to obtain bonding unless his subcontractors were approved by the surety."¹⁴⁸

¹⁴⁶ The Commission notes that Master Builders Australia announced that it was in the final stages of discussions with major insurers to provide surety bonds to its members: Vic Report 121.

In Western Australia the Housing Industry Association has introduced a voluntary bond scheme. Under the scheme builders are able to buy a bond for each house they construct. The bond will ensure that 80% of their debts over \$1 000 are paid if the builder becomes bankrupt or insolvent. Depending on the credit rating of the builder, it is estimated that bonds will cost between \$185 and \$305 for a house worth \$100,000: *The West Australian* 22 August 1997 4 "Hope for homebuyers".

¹⁴⁷ According to the Queensland Government DP 61, based on the experience in the USA, the premium could be between 1% and 2% of the project sum. Builders who are more financially, technically and managerially competent might obtain insurance at more competitive rates than less competent builders.

¹⁴⁸ Report on *Debtor Creditor Relationships: Part 2 Mechanics' Lien Act: Improvements on Land* (1972) 74.

3.63 Under the approach recommended by the Commission, small builders would not be excluded from some parts of the industry or prevented from undertaking projects because they could not obtain a bond. They could still operate under the trust scheme. Nor would insurance companies be in a position, in effect, to operate as de facto licensors since inability to obtain a bond would not disqualify a builder from carrying out construction work.¹⁴⁹

3.64 The Commission's recommendation also means that owners and contractors are in a position to balance various factors in selecting either the trust scheme or payment bonding. These factors include the premium that must be paid for a bond, the administration and accounting costs of a trust scheme and that owners and contractors whose claims on a bond were resisted after an owner or head contractor had defaulted "...would find themselves in a dispute with an insurance company of considerable size and stake in the precedents set by any judgments. ...[T]his does not augur well for the chances of small subcontractors in insisting on payment by the insurer."¹⁵⁰ Another factor that could be taken into account is that a bank providing a guarantee might require collateral which could affect the borrowing capacity of the contractor or tie up working capital.

(ii) *Notification of default in an insurance policy*

3.65 One possible difficulty with a payment bonding scheme is that an owner, head contractor or subcontractor might default on its insurance policy. To enable those who needed to take steps to protect their own interests to do so, the Commission **recommends** that the insurance company should be required to notify those covered by the bond of a default on the bond, by giving notice of the default by an advertisement in the public notice section of a newspaper circulating in the State.

(iii) *Time limitations on claims*

3.66 Unless otherwise provided, the time limit on a claim under a bond would be twenty years if a deed¹⁵¹ or six years if a simple contract.¹⁵² In its recent report on limitation periods,

¹⁴⁹ In the USA underwriters conduct stringent assessments of builders prior to underwriting their projects: Queensland Government DP 60.

¹⁵⁰ Id 61. According to the Newfoundland Report 31 payment bonding can result in lengthy and unsatisfactory litigation.

¹⁵¹ *Limitation Act 1935* s 38(1)(e)(i).

¹⁵² Id s 38(1)(c)(v).

the Commission recommended that the limitation period for contracts under seal should be the same as that for simple contracts.¹⁵³ That is, there should be a three year discovery period and an ultimate 15 year period. If the report on limitation periods is implemented, the Commission **recommends** consistent with its view in the report that there should be a uniform approach to all causes of action, that claims under a bond should be subject to a three year discovery period and an ultimate 15 year period. In the meantime, to provide some protection for sureties against claims by unknown subcontractors, the Commission **recommends** that a special time limit of three years from the final settlement or abandonment of the contract should be provided as the period within which a subcontractor could make a claim on a bond.

(iv) *Distribution of proceeds*

3.67 In some cases the proceeds of a bond may be insufficient to satisfy all claims on it. In these cases, the Commission **recommends** that the proceeds of the bond should be distributed on a pro rata basis because that is an equitable means of distribution if the proceeds are insufficient to satisfy all claims.

(v) *Inspection of a bond*

3.68 Those interested in a bond might wish to have details of its contents to ensure that it provides adequate coverage for those covered by it. To allow this to occur, the Commission **recommends** that all interested parties should have a right to inspect a bond at the business address of the owner or contractor taking out the bond.

5. MANAGED CONTRACTS WITH DIRECT PAYMENT

(a) Introduction

3.69 Another approach examined in the Discussion Paper was to require the participants in a building project to enter into a contractual relationship which more accurately reflects modern building practice by which most builders have become little more than project managers. In the mid 1970's a number of substantial buildings were constructed on that basis, usually by insurance companies and other large businesses who wanted to avoid any

¹⁵³ *Report on Limitation and Notice of Actions* (Project No 36 Part II 1997) para 12.12.

embarrassment which might arise if the builder collapsed. Under this arrangement, the builder by the terms of the contract acted purely as a manager for a percentage of the contract price and the owner paid the subcontractors direct, there being direct contracts between the owner and the individual contractors.¹⁵⁴ However, it seems to be only possible to organize a project in this fashion if the owner is a large commercial organization able to handle the accounting side of the project. Even then it might not want the high degree of involvement that is required by such a scheme. One way of avoiding the direct involvement is through a covenanting scheme, which is discussed under in the following heading.

3.70 The use of managed contracts was examined in the CIDA Report. It recommended that where a project manager is acting as agent for a disclosed principal and holds identifiable certified funds due to trade contractors, suppliers or consultants, those funds should be held in a common identifiable trust account in a financial institution.¹⁵⁵ It also recommended that the main contract and the trade, supply and consultant contracts should clearly identify with whom the trade contractor, supplier and consultant is in contract, and whether the construction manager is an agent for a disclosed or undisclosed principal.¹⁵⁶

(b) Recommendation

3.71 As the Queensland Government DP states:

"Even where progress payments pass through the manager's hands, managed contacts offer a better protection for 'subcontractors' because the work is identified in relatively small lump sum packages and is progressively paid for on an audited cost-incurred basis, with the manager receiving his/her fee proportionally. The risk to the subcontractor of the manager's default/insolvency can be completely eliminated by a system of direct payment upon certification by the manager."¹⁵⁷

Nevertheless, the Commission **does not recommend** that this approach be adopted statutorily because -

¹⁵⁴ Strictly, it would be a misnomer to call them "subcontractors".

¹⁵⁵ Recommendation 33. This recommendation was endorsed by the CIDA Board as recommendation 31.

¹⁵⁶ Recommendation 34. This recommendation was endorsed by the CIDA Board as recommendation 32.

¹⁵⁷ Queensland Government DP 32.

- * Managed contracts with direct payments do not provide the same protection for subcontractors as the trust approach if the owner becomes bankrupt or goes into liquidation.¹⁵⁸
- * It creates a contractual relationship in which the person responsible for supervising the work of the subcontractors does not have a contractual relationship with them. This could make it difficult for that person to maintain the quality of the work and could lead to disputes between the builder and the owner about the quality of the work of a subcontractor and the right of the subcontractor to payment.
- * Many owners would not have the accounting facilities to handle the accounting requirements of this approach.

6. COVENANTING

3.72 A covenanting system attempts to alleviate the late payment or non-payment of subcontractors by having payments normally paid to a head contractor paid to a covenanting agency,¹⁵⁹ which then disburses this money to the head contractor and subcontractors. The head contractor does not handle any payments to subcontractors.

3.73 Although covenanting has the advantage that it assures prompt payments to subcontractors, the Commission **does not recommend** that it be adopted statutorily because it has the following disadvantages -

1. The covenanting agency would charge a premium that would be passed on to either the owner or those receiving the payments.
2. The system would be complex. The head contractor might be required to submit a more detailed tender than is customary in the building industry

¹⁵⁸ Some payments may in fact be recoverable if the owner becomes bankrupt or goes into liquidation as unfair preferences: see H. A J Ford, R P Austin and I M Ramsay *Ford's Principles of Corporations Laws* 8th edn (Sydney: Butterworths, 1997) [27.290-27.310]; *Halsbury's Laws of Australia* (Sydney: Butterworths, 1991) [50-885].

¹⁵⁹ It would, of course, be necessary to ensure that there were agencies, such as insurance companies, that would be interested in operating as a covenanting agency.

showing the portions of the contract to be performed by subcontractors. When lodging claims for progress payments with the covenanting agency the head contractor would need to segregate the claim to show the amounts owing to it and to subcontractors.

3. It would not provide protection if the owner became bankrupt or went into liquidation. As one commentator stated: "This system only ensures distribution of the funds but in no way secures the funds".

7. IMPLIED CONDITIONS

(a) Introduction

3.74 One problem at present is that contracts may contain clauses which unfairly allocate risk between the parties with the result that the financial risk is carried by those least able to carry it. This problem can be dealt with by providing statutorily that certain conditions shall be implied in all contracts. Implied conditions are not novel in the building industry where the *Home Building Contracts Act 1991* contains a number of implied conditions.¹⁶⁰

3.75 At present, protection for payments to subcontractors is provided in some standard form contracts.¹⁶¹ For example, clause 10.5 of AS 2124-1992 provides protection for "Nominated Subcontractors":¹⁶²

"In respect of Nominated Subcontract Work performed by a Nominated Subcontractor, the Principal shall make payment directly to the Nominated Subcontractor. Except where the Contractor has accepted an assignment of the benefit of a prior contract made between the Principal and a Nominated Subcontractor -

- (a) such payment shall be made on behalf of the Contractor; and

¹⁶⁰ S 9 (implied conditions as to necessary approvals).

¹⁶¹ Examples of standard form contracts are AS 2124-1992 (prepared by the Standards Association of Australia), NPWC 3 (prepared by the National Public Works Council) and JCC- C 1994 (prepared by the Joint Contracts Committee).

Most standard form contracts have companion subcontracts which contain like conditions for the same matters. Special conditions may, however, be incorporated in contracts and subcontracts. Non-standard contracts are also used.

¹⁶² A Nominated Subcontractor is a subcontractor to whom the head contractor is directed by the owner's representative, the Superintendent, to subcontract nominated work.

- (b) if the Contractor reasonably requests the Principal in writing not to make a payment to the Nominated Subcontractor, the Principal shall withhold payment but under no circumstances, including bankruptcy or winding up of the Contractor, shall payment be made to the Contractor .

The Principal as stakeholder shall hold retention moneys and security provided by a Nominated Subcontractor and shall disburse or apply the retention moneys or security as jointly requested by the Contractor and the subcontractor or in accordance with the decision of an arbitrator or Court."

The following paragraphs contain the Commission's recommendations on whether or not certain clauses should statutorily be made implied conditions.

(b) Recommendations

(i) "Proof of payment" clauses

3.76 AS 2124-1992 provides protection for subcontractors by means of a proof of payment clause. Clause 43 of this standard contract provides:

- "(a) Before the Principal makes each payment to the Contractor, the Superintendent may, not less than 5 days before a Payment Certificate is due, in writing request the Contractor -
 - (i) to give the Superintendent a statutory declaration by the Contractor or, where the Contractor is a corporation, by a representative of the Contractor who is in a position to know the facts declared, that all workers who have at any time been employed by the Contractor on work under the Contract have at the date of the request been paid all moneys due and payable to them in respect of their employment on the work under the Contract; and
 - (ii) to provide documentary evidence to the Superintendent that at the date of the request all workers who have been employed by a subcontractor of the Contractor have been paid all moneys due and payable to them in respect of their employment on the work under the Contract.
- (b) Not earlier than 14 days after the Contractor has made each claim for payment under Clause 42.1, and before the Principal makes that payment to the Contractor, the Contractor shall give to the Superintendent a statutory declaration by the Contractor or, where the Contractor is a corporation, by a representative of the Contractor who is in a position to know the facts declared, that all subcontractors have been paid all moneys due and payable to them in respect of work under the Contract.
- (c) If the Contractor fails -

- (i) within five days after a request by the Superintendent under Clause 43(a), to provide the statutory declaration, or the documentary evidence (as the case may be) required pursuant to Clause 43; or
- (ii) to comply with Clause 43(b),

notwithstanding Clause 42.1, the Principal may withhold payment of moneys due to the Contractor until the statutory declaration or documentary evidence (as the case may be) is received by the Superintendent.

If the Contractor provides to the Superintendent satisfactory proof of the maximum amount due and payable to workers and subcontractors by the Contractor, the Principal shall not be entitled to withhold any amount in excess of the maximum amount.

At the written request of the Contractor and out of moneys payable to the Contractor, the Principal may on behalf of the Contractor make payments directly to any worker or subcontractor.

If any worker or subcontractor obtains a court order in respect of moneys referred to in Clause 43(a) or (b) and produces to the Principal the court order and a statutory declaration that it remains unpaid, the Principal may pay the amount of the order, and costs included in the order, to the worker or subcontractor and the amount paid shall be a debt due from the Contractor to the Principal.

After the making of a sequestration order or a winding up order in respect of the Contractor, the Principal shall not make any payment to a worker or subcontractor without the concurrence of the official receiver or trustee of the estate of the bankrupt or the liquidator as the case may be."

3.77 This clause may be contrasted with a "pay after paid" clause which provides that a head contractor's obligation to pay its subcontractors arises only when it has received payment from the owner or principal. "Pay after paid" clauses are of two general types: those that deal with the right to be paid ("pay if paid") and those that deal with the time for payment ("pay when paid"). If the clause deals with the right to be paid, a subcontractor has no right to be paid for its work until, for example, the head contractor receives payment from the owner. However, if a "pay after paid" clause only stipulates the time for payment, for example, when the contractor receives payment from the owner under the head contract, it does not alter the head contractor's obligation to pay the subcontractor. If the timing provision fails, for example because of the insolvency of the owner, the head contractor would be under an obligation to pay the subcontractor within a reasonable time.¹⁶³

¹⁶³ See generally D S Jones *Structuring Contracts to Protect Against Insolvency* (1991) 21 ACLN 34, 47-48.

3.78 One approach to reform examined in the Discussion Paper is to require statutorily that all written head contracts contain "proof of payment" clauses along the lines of clause 43 unless there was provision for direct payment along the lines of clause 10.5.¹⁶⁴ As a corollary, "pay after paid" clauses could be declared void. The result of the statutory adoption of a clause along the lines of clause 43 is that a head contractor would have to pay subcontractors before it received payment from the owner.¹⁶⁵ The head contractor would no longer have the use of those parts of progress payments payable to subcontractors during the period between when they were paid by the owner and when they paid the subcontractor. The head contractor would, therefore, bear the risk of each progress payment, a risk it could insure against, and fund payments to subcontractors before it obtained the progress payment from the owner. The CIDA Report recommends that all contracts contain "proof of payment" clauses.¹⁶⁶ It also concluded that proof of payment clauses in existing standard form contracts were inadequate and recommended that industry contract committees be asked to include an appropriate proof of payment clause in all head contracts based on principles enunciated by it.¹⁶⁷

3.79 In view of the Commission's recommendation that a trust scheme be introduced, the Commission **does not recommend** that a proof of payment clause be implied statutorily in all relevant contracts. It does not provide as much protection as a trust scheme because it does not provide a means of keeping money within the contractual chain should one of the parties become bankrupt or insolvent after work has been done or materials supplied but before a payment is made. Even if a trust scheme is not introduced, the Commission does not favour implying proof of payment clauses in all relevant contracts because -

1. It would mean head contractors and others in the contractual chain would need to obtain finance or use their own capital to meet their payments before receiving payment from the party above them in the contractual chain.
2. It would increase the paperwork required at every step in the contractual chain.

¹⁶⁴ The subcontractor's right could be enforced under s 11(2) of the *Property Law Act 1969*: see footnote 17 in Ch 1.

¹⁶⁵ The CIDA Report (at 30) recommended that paid if paid clauses should not be used and that signatories to the Construction Industry In-principle Reform and Development Agreement should ensure that conditions of tender prohibit the use of such clauses. No recommendation was made with regard to "pay when paid" clauses (31). These recommendations were endorsed by the CIDA Board as recommendations 17 and 18.

¹⁶⁶ Para 2.4 above.

¹⁶⁷ Ibid.

3. The problem of paperwork would be increased further if the problem of fraud were to be addressed. It has been suggested to the Commission that proof of payment clauses in some government contracts are not effective because builders make false declarations with some impunity.¹⁶⁸ One means of curtailing it might be to require that the statutory declaration be accompanied by receipts for payments to the subcontractors but this would increase the paperwork. Even this might not prevent abuse by unscrupulous contractors because as the CIDA Exposure Draft comments "...it is easy enough for a contractor to 'invent' a dispute in order to justify declaring that payment is not due to the subcontractor because the amount of payment is in dispute."¹⁶⁹

3.80 Pay if paid clauses shift the risk of non-payment by the owner from the head contractor to its subcontractors. Pay if paid clauses may be criticised on the following grounds-

- * The subcontractor bears the risk of the owner's liquidity even though it might not be reasonable to expect the subcontractor to inquire into the financial position of the owner, a participant in the project with which it has no contractual relationship. Head contractors are better placed than subcontractors to inquire into the financial status of the owner by checking the history, credit line and payment practices of the owner.
- * The payment may depend on a condition over which the subcontractor has no control. For example, in *Dunlop & Ranken Ltd v Hendall Steel Structures Ltd, Pitchers Ltd (Garnishees)*¹⁷⁰ the court held that a payment did not have to be made where the contract provided for payment to be made on the receipt of an architect's certificate under the head contract but one certificate from the architect had not been issued.

¹⁶⁸ The Master Painters, Decorators & Signwriters' Association of Western Australia; The Master Plumbers & Mechanical Services Association of Western Australia. Western Power, which has a proof of payment clause in its General Conditions of Contract similar to cl 43 of AS 2124-1992, said that the clause was "largely ineffective". It pointed out that the clause provides no security if the contractor is prepared to make a false declaration. Similar comments about the ineffectiveness of declarations due to dishonesty of builders were made by commentators on the Discussion Paper. The CIDA Exposure Draft (47) also noted that it had been reported that "statutory declarations are often sworn by persons who are not in a position to know whether sub-contractors have been paid and there are reports of the presentation of false declarations."

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[1957] 1 WLR 1102.

- * A head contractor may rely on its own wrong, for example, where the owner is entitled to set-off against it in relation to the project contract, to defeat a bona fide claim by a subcontractor.
- * Pay if paid clauses prevent a subcontractor from claiming on a bond or trade indemnity insurance policy. The surety or insurer may defend the claim for payment on the ground that the payment is not due to the subcontractor until the head contractor has been paid by the owner.¹⁷¹
- * A subcontractor could not reasonably be expected to take the risk of non-payment into account in fixing the price for its portion of the work. It is difficult for a subcontractor to factor into a tender the risk of delay or non-payment because the subcontractor is not in a position to assess the financial viability of the owner and others above it in the chain of contracts.

For these reasons, it is fairer for the head contractor to bear the risk and, perhaps, insure against it. Accordingly, the Commission **recommends** that pay if paid clauses should be made void.¹⁷² In any case, standard form contracts do not necessarily contain such clauses.¹⁷³

3.81 "Pay when paid" clauses, which deal with the time for payment, may also be considered to be unfair because payment of the subcontractor is delayed until the head contractor receives a payment from the owner.¹⁷⁴ However, the head contractor must eventually pay the subcontractor within a reasonable time even if it is not paid by the owner.¹⁷⁵ Further, the Commission recommends below¹⁷⁶ that there should be a statutory maximum payment period of 30 days and that there should be realistic interest rates on late payments. In view of these matters, the Commission **does not recommend** that "pay when paid" clauses should be made void.

¹⁷¹ *Trade Indemnity Australia Limited v Parkinson Air-Conditioning Pty Ltd* (1994) 13 ACLR 19.

¹⁷² The CIDA Report (Recommendation 18) recommends that "paid if paid" clauses should not be used and that signatories to the *Construction Industry In-principle Reform and Development Agreement* should ensure that conditions of tender prohibit the use of such clauses. This recommendation was endorsed by the CIDA Board as recommendation 17.

In the United Kingdom pay if paid clauses are ineffective except in specified circumstances: para 2.55 above.

¹⁷³ See eg SC.JCC.A 1985.

¹⁷⁴ According to D S Jones *Structuring Contracts to Protect Against Insolvency* (1991) 21 ACLN 34, 47 "...the clause is intended to protect the cashflow of the contractor during the course of building works."

¹⁷⁵ Para 3.77 above.

¹⁷⁶ Para 3.92 above.

(ii) Proof of funding

3.82 Another means of protecting subcontractors, and head contractors, is by means of an implied condition which requires the owner to provide proof of project funding prior to the commencement of work. The CIDA Report recommended that the industry contract committees consider including this type of clause in the standard contracts.¹⁷⁷

3.83 One shortcoming of a trust scheme is that the owner may not have adequate funding to meet the cost of a project. If this occurred, the trust fund would have to be distributed to its beneficiaries on a pro rata basis.¹⁷⁸ However, according to one submission by a special subcontractors group, the incidence of owner insolvency is low and generally adequate funds are available for each project. Accordingly as proof of funding clauses do not appear to be necessary and would be burdensome, the Commission **does not recommend** that they should statutorily be made implied conditions.

(iii) "Romalpa" or retention of title clauses

3.84 Another type of clause which could be made a statutory implied condition is a "Romalpa" or retention of title clause.¹⁷⁹ This type of clause ensures that property in goods and materials supplied but not yet incorporated into a building does not pass to the owner until the contractor is paid. This means, for example, that if the head contractor terminates a contract because the owner has become insolvent, the contractor can obtain all goods and materials which have not been incorporated into the building. Those that have been incorporated cannot be obtained because, having become part of the land and property, they will have passed to the owner.¹⁸⁰ In effect, the Romalpa clause provides security for the unpaid price of goods sold.¹⁸¹

¹⁷⁷ Para 2.2 above.

¹⁷⁸ Para 3.47 above.

¹⁷⁹ See the analysis of such a clause by Goff LJ in *Clough Mill Ltd v Martin* [1985] 1 WLR 111, 117-118.

¹⁸⁰ See *R J Grills Pty Ltd v Dellios* [1988] VR 136, 139.

¹⁸¹ According to Darter and Sharkey, at para 10.20, the elements of a good retention of title clause will generally be:

- "(a) property not to pass until payment;
- (b) separate storage and clear identification as the supplier's property;
- (c) further dealing to be as bailee and fiduciary agent, together with an obligation to hold the proceeds in a separate account;
- (d) an obligation to account and provide other relevant information; and
- (e) licence to enter subject premises for the purpose of obtaining possession."

3.85 Retention of title clauses are used in subcontracts at present¹⁸² and contracts prescribed under the *Home Building Contracts Act 1991*¹⁸³ for various kinds of home building work which are taken to comply with all the requirements of the Act.¹⁸⁴ Where there is a breach of a retention of payment clause the remedy will be either damages or an injunction to prevent dealings with the materials and obstruction of the contractor's attempts to recover the material.¹⁸⁵

3.86 As one means of protecting contractors, subcontractors and suppliers, the Commission **recommends** that a retention of title clause should be implied in all contracts in the building and construction industry. The sale of goods subject to title retention has been reviewed by the Australian Law Reform Commission as part of its review of personal property security. It recommended that title retention clauses should be subject to the personal property security regime it recommended be adopted because:¹⁸⁶

"Title retention devices are mostly used as a means of providing to purchasers the financial accommodation necessary for them to acquire property. Their economic or commercial function, whatever their legal form or character, is to facilitate commercial transactions in the same way that traditional lending by financial institutions facilitates commercial activity. Indeed, it is a matter of choice for a financial institution whether it provides finance directly or, using this method, indirectly. ...Secondly, the position of a third party dealing with a person in possession of property subject to a title retention arrangement is in substance no different to the position of a third party who deals with a person in possession of goods subject to an ordinary security interest."¹⁸⁷

Under the regime the Australian Law Reform Commission recommended, priority rules would be set which would determine the order in which secured creditors would take if the security has been realised and would determine when a buyer of secured property is free of the security interest, that is, when buyers of secured property get good title and the security

¹⁸² For example one subcontract, SC.JCC.A 1985 cl 10.06, provides that any unfixed materials or goods:
" ...shall as between the Sub-Contractor and the Builder become the property of the Builder upon payment by him to the Sub-Contractor of the amount of the value thereof and thereafter the Sub-Contractor shall not remove the same except for use in the Sub-Contract Works (unless the Builder shall have in writing authorised removal)".

¹⁸³ S 15(5)

¹⁸⁴ For example, the *Home Building Contracts Regulations 1992* Sch 3 contains the Lump Sum Building Contract for Minor Works, cl 5(b) of which provides:

"Title in any goods delivered to the Site under the Contractor's obligations pursuant to this Contract shall not pass to the Owner until the progress payment which incorporates such goods in the stage of completion referred to in the Schedule has been paid by the Owner. Upon receipt of such payment by the Contractor, title in such goods shall be deemed to have transferred to the Owner."

¹⁸⁵ See *Aristoc Industries Pty Ltd v R A Wenham (Builders) Pty Ltd* [1965] NSW 581.

¹⁸⁶ Australian Law Reform Commission *Personal Property Security* (Report No 64 Interim, 1993) para 5.24.

¹⁸⁷ Ibid.

interest is extinguished. A secured party would be able to protect its interest by registration of a notice of the interest in a public register.¹⁸⁸ This report has not been implemented as yet.¹⁸⁹ If it was adopted and retention of title clauses were implemented in all contracts in the building and construction industry, they might be subject to the legislation implementing the Australian Law Reform Commission recommendations.

(iv) *Assignment of progress payments*

3.87 Where the funds for a project are not provided by the owner but are advanced to the owner by its financier the head contractor usually receives progress payments from the owner, not the financier. As the owner usually only receives these funds from the financier on production of progress certificates, the head contractor will not receive these funds if the owner becomes insolvent between the time when the funds have been advanced by the financier and the time when they are passed on to the head contractor. One means of protecting the head contractor against loss in this situation examined in the Discussion Paper is an implied condition providing for direct payment from the financier to the head contractor upon receipt of the progress certificate by the financier. In view of the Commission's recommendation that all amounts received by the owner that are to be used in the financing of the improvement should constitute a trust fund for the benefit of the head contractor,¹⁹⁰ the Commission **does not recommend** that it should be implied statutorily that there should be direct payment from the financier to the head contractor upon receipt by the financier of the progress certificate.

(v) *Payment of liquidated damages*

3.88 The CIDA Report drew attention to abuses of a provision in contracts relating to the payment of liquidated damages. It said that some head contractors required subcontractors to pay the total amount of liquidated damages payable by the head contractor under the head contract even though a subcontractor may have been only partially responsible for the delay which caused the head contractor's liability to the owner for liquidated damages.¹⁹¹ To prevent this abuse from occurring, the Report recommended that standard form contracts should

¹⁸⁸ Id para 5.2.

¹⁸⁹ See Australian Law Reform Commission *Annual Report 1996 84*.

¹⁹⁰ Para 3.25 above.

¹⁹¹ CIDA Report 36. See also CIDA Exposure Draft 79.

incorporate the principle that "no party in the contractual process should be liable for more than the cost of the consequences of its actions".¹⁹² That is, where a subcontractor's breach is not the sole cause of the head contractor's liability, it should indemnify the head contractor only in proportion to its responsibility. The Commission endorses this recommendation and **recommends** that such a provision should statutorily be made an implied condition in contracts in the building and construction industry.

(vi) *Suspension of works*

3.89 At present some standard contracts provide for the suspension of the works because of an act or omission of the owner.¹⁹³ Such clauses limit a head contractor's liability should it ultimately become necessary to terminate a contract because of a default by the owner. To ensure that such protection was provided, the CIDA Report recommended that all contracts should contain a right to suspend the work for failure to make payment, with a further right to terminate the contract if non-payment continues.¹⁹⁴ The Commission endorses this recommendation and **recommends** that such a provision should statutorily be made an implied condition in contracts in the building and construction industry.

(vii) *Retention funds*

3.90 A number of those who made a preliminary submission to the Commission suggested that retention funds should be held in trust.¹⁹⁵ Otherwise these funds could be allocated to other accounts or projects. At least one of the standard form subcontracts provides for retention funds to be held in a joint account or in trust.¹⁹⁶ Another provides:

"The interest of the Builder in the amount so retained shall be fiduciary as trustee for the Sub-Contractor but subject to the provisions of Clause 10.26 and without any

¹⁹² CIDA Report recommendation 24. It gave as an example of such a clause, clause 10.16 of SC.JCC. This recommendation was endorsed by the CIDA Board as recommendation 23.

¹⁹³ See eg AS 2124-1992 cl 34.1. According to the CIDA Exposure Draft at 79, AS 2545-1993 has equivalent provisions. The CIDA Exposure Draft at 79 also states that JCC-C 1993 and JCC-D 1993 give the builder an option to terminate or suspend a contract for breach of contract by the owner and that the companion subcontracts give a subcontractor a similar right.

¹⁹⁴ CIDA Report recommendation 25. This recommendation was endorsed by the CIDA Board as recommendation 24.

¹⁹⁵ Air Conditioning & Mechanical Contractors' Association of Western Australia; The Australian Institute of Building; Architectural Aluminium Fabricators Association of Western Australia; The Master Painters, Decorators & Signwriters' Association of Western Australia; The Master Plumbers & Mechanical Services Association of Western Australia.

¹⁹⁶ AS 2545-1993 cl 5.9.

obligation on the part of the Builder to invest the same or account for any advantage that he may derive from the moneys so retained."¹⁹⁷

The CIDA Report pointed out that subcontractors consider retention money to be unsatisfactory because it ties up cash flow and the money may be lost if the contractor becomes insolvent.¹⁹⁸

3.91 The CIDA Board recommended that, except where government departments or agencies are involved, all contracts should contain:

"...a provision that the party holding security in the form of cash or retention moneys establish a common identifiable account in a financial institution into which security must be paid, and held in trust, in the absence of other mechanisms for payment of security in the event of insolvency."¹⁹⁹

This would prevent funds being lost on the contractor's insolvency. The Commission agrees with this approach and **recommends** that it should be provided statutorily that a party holding security in the form of cash or retention moneys is deemed to hold those monies in trust. This recommendation would not, of course, overcome the subcontractor's concern that part of their cash flow is tied up. To overcome this problem, the Commission **recommends** that a contractor or subcontractor should be entitled statutorily to provide some other form of security such as bonds or an unconditional undertaking given by an approved financial institution or insurance company in lieu of cash or retention monies.²⁰⁰ Where retention money is held in trust, the Commission **recommends** that the contractor or subcontractor from whom the money is withheld should receive any interest paid on the money held in trust²⁰¹ because the money is money that is otherwise due to it and is held solely to secure the owner or builder against the contractor's or subcontractor's defective workmanship or materials.

¹⁹⁷ SC.JCC.A 1985 cl 10.24.05.

¹⁹⁸ According to a study published in the CIDA Exposure Draft almost no retention money was recovered in cases of insolvency: Appendix B 17 Table 8.

¹⁹⁹ Recommendation 30.

²⁰⁰ Some contracts provide for alternative security at least with the approval of the party having the benefit of the security: AS 2545-1993 cl 5.3 and SC.JCC.A 1985 cl 10.22-10.23.

²⁰¹ Unlike the position under AS 2545-1993 cl 5.9 which provides that:

"A party holding retention moneys or cash security shall own any interest earned on the retention moneys or security."

(viii) Payment terms

3.92 As stated above,²⁰² delays in payments to subcontractors create cash flow problems. This is potentially a serious problem for individual subcontractors in an industry marked by undercapitalisation. To address this problem the Commission **recommends** that it should be provided statutorily that there should be an implied term of a maximum period for the payment of participants in the industry of 30 days²⁰³ and there should be realistic interest rates on late payments. This recommendation is consistent with the plan for national action on security of payment in the construction industry²⁰⁴ under which Government principals would require that moneys due to project participants down the contractual chain are paid within a specified time, once payment is due to the head contractor. Prompt payment legislation is used in the United States of America where payment periods range from seven to 45 days.²⁰⁵ Implementing this recommendation should not result in an overall increase in construction costs. While head contractors might have increased project funding costs, those of subcontractors should be reduced because they will no longer have to attempt to build the additional funding costs into their contract price.

8. INSURANCE APPROACH**(a) Introduction**

3.93 At present it is possible for a head contractor or a subcontractor to protect itself with credit indemnity insurance. However, the premiums may be too high in relation to the profit margins.²⁰⁶ This may be because profit margins in the building industry have diminished through highly competitive tendering. On the other hand it may be that contractors insure only the risky jobs and the premiums are geared to this fact.

²⁰² Para 1.19.

²⁰³ The practice in the residential sector has been to pay subcontractors weekly or fortnightly but this practice appears to have changed with payments being delayed for up to 120 days: para 1.19 above, footnote 34. A maximum period would not, of course, preclude payment within a shorter period or payments being made weekly or fortnightly.

²⁰⁴ Para 2.10 above.

²⁰⁵ Paras 2.57-2.58 above.

²⁰⁶ The SA Working Party at 13 suggested a scheme providing cover of up to \$40,000 in anyone year for one licensee could be set up for an annual premium of about \$100.00 (plus stamp duty in SA of \$8.00). BISCOA(SA) at 7 criticised this suggestion because a limit of \$40,000 would be inadequate in commercial developments.

3.94 The Housing Industry Association attempted to develop a credit indemnity scheme to protect member subcontractors against the insolvency of contractors. However, the cover provided under the scheme ceased because the premium, which was included in the subscription for subcontractor members, was inadequate to meet claims on the fund. Following this failure, the South Australian Division of the Housing Industry Association developed a more attractive scheme in which the Division underwrote the first \$50,000 in claims to reduce the level of premiums paid. Although a telephone marketing campaign to approximately 10,000 subcontractors in South Australia was conducted, only 150 subcontractors obtained cover. As little interest was shown in the scheme, it was withdrawn from the market.

3.95 The Housing Industry Association suggested that the failure of the scheme in South Australia indicated there was no "great need for such a service or indeed for any form of legislative protection". The lack of interest may, however, have been due to the narrow margins in the industry and a reluctance to incur the additional cost of the premium. Another factor contributing to the lack of interest may have been the fact that subcontractors in the residential sector are generally paid weekly or fortnightly, which minimises their exposure to loss due to the insolvency of head contractors or owners.

(b) Recommendation

3.96 In view of the failure of voluntary schemes, if an insurance approach were adopted, a compulsory insurance pool would be required so that losses could be spread over everyone in the industry.²⁰⁷ An insurance scheme has the advantage that it does not interfere with the day to day running of the project and does not restrict the cash flow in any way. Also since each party insures itself against loss, the structure of the project would not be affected. Where there is a compulsory scheme the cost of premiums may not increase building costs because any sums built into contracts to cover losses would no longer be necessary and competition in the industry would lead to their removal from contracts.

²⁰⁷ The SA Working Party at 13 recommended the adoption of trade indemnity insurance though it concluded that further investigation was required to determine if the scheme needed to be mandatory. BISCOA (SA) at 5 opposed a compulsory scheme of insurance because it would encourage bad practices in the industry. BISCOA (Qld) at 18 also opposed a mandatory scheme on the ground that it would be ineffective.

3.97 There are two major arguments against introducing a compulsory insurance pool. First, it is not appropriate to compel subcontractors who are capable of protecting their own interests to participate in a scheme. Secondly, "...the capacity for fraud...is monumental, given that it would be open to the parties to negotiate contracts incapable of being performed because at the end of the day that performance will be underwritten by a massive statutory insurance scheme."²⁰⁸ For these reasons, the Commission **does not recommend** that a compulsory insurance scheme be introduced.

9. STOP NOTICE

(a) Introduction

3.98 A stop notice is a statutory procedure by which a subcontractor can force undisbursed funds which the owner may owe to the builder under the head contract to be held for its own payment. It would not be necessary if a contract contained a proof of payment clause.²⁰⁹ Upon the receipt of a bonded²¹⁰ stop notice, the owner (or its lender) is required to withhold sufficient funds from the head contractor to satisfy the claims of subcontractors. That is, the funds are held in a type of escrow account. They are released if the head contractor pays the subcontractor. If the head contractor is not able to make the payment, there are two ways in which the subcontractor can acquire his part of the escrow account. First, if the head contractor sues the owner, the owner may pay the amount due under the contract into court. All persons, including the subcontractor, entitled under the amount due under the contract are made parties to the action, and the court may direct the payment and the amount due under the contract. Secondly, the subcontractor may sue the head contractor. The owner and all "other interested parties", so far as known, must be made parties to the action. The owner may pay into court the amount admitted to be due under the contract or sufficient to pay the sums claimed. The court then determines who is lawfully entitled to payment. Irrespective of the means by which the claim is asserted, the owner is not liable for a greater amount than the amount due to the head contractor under the construction agreement. If the head contractor assigns its rights to the proceeds of the contract to a financial institution, that institution's right to the contract proceeds is subordinate to the rights of the subcontractor.

²⁰⁸ Queensland Government DP 58.

²⁰⁹ Paras 3.78-3.79 above.

²¹⁰ That is, an undertaking that the subcontractor will pay all costs that may be awarded against the owner or lender.

(b) Recommendation

3.99 An advantage of a statutory stop-notice scheme is that, regardless of the order the subcontractors follow in filing their stop-notice, all filing subcontractors share pro rata in the contract proceeds if such proceeds are insufficient to satisfy all claims,²¹¹ the owner not being liable for a greater amount than the amount contracted for with the head contractor. The major shortcoming of the stop notice procedure is that it does not provide protection if the owner becomes bankrupt or insolvent. It also has the following limitations -

1. A subcontractor has no right to the stop notice unless the head contractor is entitled to payment under the contract. The owner must therefore be indebted to the contractor under the contract at the time the stop notice is filed.
2. A subcontractor has no right to a stop notice unless the head contractor is indebted to it at the time the stop notice is filed. Those further down the chain from the subcontractor of the head contractor have no stop notice right in relation to the owner's undisbursed contract funds.
3. It freezes only the undistributed contract funds in the hands of the owner at the time of the notice. The subcontractor must, therefore, file its notice with the owner before the owner disburses all the contract funds.
4. It may adversely affect the flow of funds from the owner to the builder which could have an unfortunate effect on the project because the owner may have to set aside funds needed to continue construction.

3.100 Several practical factors also limit the effectiveness of a stop notice:

"In many small construction contracts, only one or two payments are made by the owner to the prime contractor. Since a subcontractor frequently will not be paid until the prime contractor is paid, it is often too late to file a stop-notice in such a contract; therefore, it is apparent that the subcontractor can lose his right to file a stop-notice before he even learns of the need to file. ...The disruptive effect of a stop-notice also

²¹¹ W L Smith and B S Hazard "Mississippi Law Governing Private Construction Contracts: Some Problems and Proposals" (1976) 47 *Mississippi LJ* 437, 463.

limits its effectiveness. Since the notice frequently results in a halt in construction, many subcontractors are reluctant to use it, fearing business retaliation from their own or other prime contractors. In times of little construction, this limitation is even more stringent. In fact, it is not uncommon for the promise of not asserting a stop-notice to be an express or implied prerequisite to acquiring the subcontract.²¹²

In view of the shortcomings and limitations of the stop notice procedure referred to above, the Commission **does not recommend** that it be introduced in Western Australia.

10. HOLDBACK FUND

(a) Introduction

3.101 Under a holdback scheme the owner is required to retain a percentage of the contract price (say 10%) for a period of time after construction has been completed.²¹³ Subcontractors may claim on this fund²¹⁴ if they have not been paid by the head contractor. Claims which are met from the fund may be deducted from the amount ultimately due to the head contractor. Usually, if the owner fails to retain the holdback money, the claimants are entitled to a lien on the property to the extent of the amount of funds they would have received had the money been withheld. It was developed as a means of protecting those who had enhanced the value of a property yet in the absence of privity of contract with the owner had no direct claim against the owner.

(b) Recommendation

3.102 The Commission **does not recommend** that a holdback scheme be adopted because it has the following disadvantages or has been criticised for the following reasons.²¹⁵

1. It restricts the ready flow of some funds along the construction chain and could cause cash flow problems for contractors and subcontractors who must finance

²¹² Id 456.

²¹³ Such a scheme may also involve money being withheld at each level of the construction pyramid.

²¹⁴ According to the Alberta Report at 16:

"Although the rationale for a statutory holdback is to provide a sum of money which will be available to at least partially satisfy lien claimants, in fact it is not a specific pool of money but is rather a notional concept which only comes into being in the event that the owner decides to pay it into court in order to clear his title of liens."

²¹⁵ The Alberta Report recommended that the statutory holdback be eliminated as part of a reform which involved the introduction of statutory trust provisions because it could be done without any significant loss of security for subcontractors: Alberta Report 16.

the difference between what is received and must be paid, for example, for labour and materials. The Alberta Report also pointed out that higher statutory holdbacks cause difficulties:

"The reality, however, is that the statutory holdback of 15% causes a serious deficiency in the cash flow of contractors and subcontractors, which may contribute to insolvencies and business failures. That is, rather than being part of the solution, in some cases the statutory holdback is part of the problem."²¹⁶

2. It adds to the cost of a project. One survey in the United States of America indicated that prices could be reduced by an average of 3.2 percent if the holdback was eliminated.²¹⁷
3. Undue reliance upon the holdback leads to poor business practices because proper credit checks are overlooked.

11. GRADING OR LICENSING OF BUILDERS

3.103 The grading of builders by way of a licensing scheme was recommended by Mr C H Smith QC in his report *Inquiry into the Building Industry of Western Australia 1973-1974*.²¹⁸ Mr Smith recommended that there should be three types of licence:

- (i) a general construction licence which would entitle the holder to undertake any type of building work of any value,
- (ii) a limited builder's licence which would entitle the holder to undertake construction of housing to an unlimited value and other construction work to a limited value of say \$30,000,
- (iii) a sub-contractor's licence which would entitle the holder to undertake the type of work specified in the licence to an unlimited value.²¹⁹

Mr Smith also recommended that the licensing authority should be required to satisfy itself before issuing a licence that the individual company or firm seeking to be licensed had the technical skill, business training and financial resources to carry out the type of work for

²¹⁶ Ibid.

²¹⁷ Newfoundland Report 29. Subsequently the USA Government eliminated the holdback from all of its projects for this reason: *ibid*.

²¹⁸ Smith Report paras 7.26- 7.28.

²¹⁹ *Id* para 7.26

which the licence was sought.²²⁰ The financial status of licensees would, at the discretion of the authority, be reviewed at the time of renewal of licenses.²²¹

3.104 As the industry is structured at present a builder with few assets of its own can satisfactorily build large office blocks and other developments involving large sums of money. Under the scheme proposed by Mr Smith, head contractors would be limited to contracting for work the value of which was in accordance with their skill, training and financial resources. At present, the Builders' Registration Board may require an applicant for registration under the *Builders' Registration Act 1939* to satisfy it that the applicant has sufficient material and financial resources available to enable it to meet its financial obligations as and when they become due. The Board may refuse to register an applicant which fails to so satisfy it.²²² The Board may also hold an inquiry into the financial resources of a registered builder and may suspend or cancel the registration of a builder who does not have sufficient financial resources to meet its financial obligations.²²³ Although the intention of the inquiry is to reduce the likelihood of builders getting into financial difficulties it has been criticised as being ineffective because it is likely that a builder will be in severe financial difficulty before an inquiry is instituted.²²⁴

3.105 In comments on the Discussion Paper, the Housing Industry Association criticised the existing registration process because it allows any registered builder to undertake any form of building and the educational requirements for all builders are the same even though different training is necessary for those involved in building residences and those involved in building office towers. It suggested that:

"...the training requirements be more appropriately targeted at the particular sector in which the builder will be operating, based on a modular course structure allowing qualification as a residential or commercial builder on completion of the necessary modules."

The Housing Industry Association also suggested that there should be greater monitoring of the level of activity, rate of growth and quality of workmanship of builders by the Builders' Registration Board.

²²⁰ Id para 7.27.

²²¹ Ibid.

²²² *Builders' Registration Act 1939* ss 9A(2) and 10(2a). The SCGA Report at 41-42 recommends that these provisions be repealed because the information provided by an applicant soon becomes outdated.

²²³ *Builders' Registration Act 1939* s 13(1)(ba).

²²⁴ SCGA Report para 5.16.

3.106 The Association also considered that there was a need to improve the training course for registration as a builder to improve builders' business and financial management ability. It also suggested that there should be continuing education in the areas of financial management, legal requirements and technical expertise.

3.107 In Queensland it has been suggested that licence qualifications should emphasise bookkeeping and record management, financial skilling with particular emphasis on appropriate debt ratios, relevant technical experience, cost estimating, tender preparation and administration and other management skills.²²⁵ In comments on the Queensland Government DP, BISCOA (Qld) at 10 suggested that there should be a graded registration system for both builders and subcontractors which would take into account their experience and capability, financial soundness and management skills. Using these criteria "...a system of points could be awarded for each category of the criteria and then quantum levels of work could be established, in which companies may operate and tender upon."

3.108 In South Australia, the Ministerial Working Party recommended that applicants for builder's licences should meet certain prudential requirements, demonstrated by financial recourse to one or more of the following -

- * personal guarantees to a certain value covered by registered securities over specific assets;
- * bank guarantees to a certain value;²²⁶
- * indemnity insurance to a certain value;
- * use of independently audited trust funds to hold prepayments; or

²²⁵ Queensland Government DP 16.

The SA Working Party at 4 proposed that, as part of the licence requirements, participants in the industry should "demonstrate their understanding of the principles of risk management and the need to better manage their debtors."

The CIDA Report recommended that a set of common criteria to assess the character, financial and technical capacity of those seeking registration should be developed: CIDA Report 7. This recommendation was endorsed by the CIDA Board as recommendation 2.

²²⁶ BISCOA (SA) at 6 criticised such a requirement. It stated that:

"Such a requirement would be detrimental to the on going operation of the contractor who will have his available assets significantly limited. Furthermore, there will be problems if an insolvency does occur with cross claims by the liquidator over these funds."

- * other financial recourse as agreed to by the Commercial Tribunal, which is responsible for issuing those licences.

In the event of insolvency, the financial backing would be used to cover the debts of the licence holder.²²⁷ In this State, the SCGA Report recommended that each applicant for registration should be required to produce to the Builders' Registration Board a cash redeemable guarantee from a financial institution.²²⁸

3.109 The Ministerial Working Party also recommended that there should be more stringent and more effective monitoring of builder's licences, with an expanded role for the Commercial Tribunal. The Working Party recommended that the Tribunal provide an "early warning" of impending financial problems by allowing it to deal with complaints of the late or non-payment of subcontractors. The Tribunal could require licence holders to seek specific assistance, such as business expertise, to overcome problems.²²⁹

3.110 While the Commission does not oppose providing more stringent criteria for licensing builders or grading builders or improving the education of builders, it is not convinced that these measures will prevent the financial failure of builders, because any builder, once registered, is capable of trading imprudently and becoming insolvent. It therefore **does not recommend** that more stringent criteria or that grading of builders be introduced as means of dealing with the matters raised by the Commission's terms of reference. To be reasonably effective, it would be necessary for the Builders' Registration Board continually to monitor the financial soundness of builders. However, this would require considerable resources and would add significantly to the administrative costs of the Board. More stringent criteria for registration or grading of builders would also have the effect of excluding some builders from the whole or a part of the industry with a consequent reduction in competition. The new indemnity insurance scheme which has recently been introduced²³⁰ may, in any case, exclude some builders from the home building sector of the industry because they will not be able to obtain insurance. A grading scheme could also unfairly deprive smaller builders of an opportunity to expand their business. It may also be difficult to develop objective criteria for registration of builders or deciding for what grade of builder they should be granted.

²²⁷ SA Working Party 12.

²²⁸ 41-42.

²²⁹ SA Working Party 11.

²³⁰ Para 3.6 above.

3.111 An alternative would be to require that all registered builders be required to have their financial records audited annually and supply an audit certificate to the Board.²³¹ The cost would be between \$3,000 and \$10,000. However, it would also be necessary for the Board to monitor the performance of builders and conduct random inspections of the financial records of builders. Once again, while the Commission does not oppose this proposal, it is not convinced that it will prevent the financial failures of builders.

²³¹ The Australian Society of CPA's Centre of Excellence for Insolvency and Reconstruction made such a suggestion for builders with an annual turnover exceeding \$1 million.

Chapter 4

SUMMARY OF RECOMMENDATIONS

SPECIAL PROVISION FOR THOSE IN THE BUILDING AND CONSTRUCTION INDUSTRY

1. The law should be amended to regulate the payment of head contractors, subcontractors, workers and others in the building and construction industry.

Paragraphs 3.1-3.6

TRUST SCHEME

A trust scheme should be introduced

2. A trust scheme should be established statutorily in the building and construction industry.

Paragraphs 3.9-3.22

The trustee should not be a government body

3. The responsibility of being the trustee should not be given to a government body but the trustee should be permitted to be one of the participants in the construction project.

Paragraph 3.23

A trust should attach to funds in the owner's hands

4. To provide maximum protection for the head contractor and others involved with a project, where the owner provides its own capital, moneys in the hands of the owner to pay, or funds received by the owner or earmarked by the owner to pay, for the improvements should be held in trust for the benefit of the head contractor.

Paragraph 3.24

5. All amounts received by the owner or advanced by a financier that are to be used in financing the improvement, should be held in trust for the benefit of the head contractor, that is, a trust should arise in relation to the funds at the time the financier

is required to advance the funds to enable the owner to meet a progress payment or final payment to the head contractor.

Paragraph 3.25

6. An owner building his own home should be subject to a fiduciary duty to hold moneys on account of the contract for the benefit of the head contractor.

Paragraph 3.26

Each participant who is under an obligation to another participant or a project should be a trustee

7. Each participant in the construction project who holds or receives a payment on account of the contract and is under an obligation to pay another participant should hold those moneys as a trustee.

Paragraph 3.27

The "privity or trust" approach should not be adopted

8. Each trustee should be required to hold funds for all those down the chain from it.

Paragraph 3.28

9. Moneys received by one subcontractor should not be held in trust for those in the chain below another subcontractor.

Paragraph 3.29

10. A trustee's obligations to the beneficiaries should be fully discharged when the trustee has paid in full the parties with whom it contracted.

Paragraph 3.30

The trustee should be required to keep a separate trust account

11. A trustee, including an owner building his own home, should be required to keep trust funds in a trust account, separate from its general banking account.

Paragraph 3.32

A trustee should in certain cases have the option of having a separate trust account for each project or a single consolidated account

12. Trustees (whether an owner building his own home, a contractor or a subcontractor) should be required to open a separate trust account for each project. However, trustees should have the option of using a single consolidated trust account with the approval of the Builders' Registration Board if they can demonstrate that they can maintain books of account of all trust moneys received, deposited or disbursed in such a manner as to disclose the true position as regards those moneys in relation to particular projects and to enable the books to be readily and conveniently audited. If this option is taken, the account should be audited annually

Paragraph 3.34

Withdrawal of money from the trust fund by the trustee

13. A trustee who is a head contractor or a subcontractor should be able to withdraw the balance of trust funds when the project is completed, so long as all obligations to its beneficiaries have been met.

Paragraph 3.35

14. A trustee should be able to withdraw money from a trust fund before a project is completed so long as there is sufficient money left in the fund to pay the beneficiaries the moneys owing to them in full.

Paragraph 3.35

15. Where a trustee pays for materials, service, labour or rented equipment for the project out of its own funds, the trustee should be allowed to withdrawal from the trust fund of an amount equal to the sum paid. Such a withdrawal should not constitute a breach of trust so long as the fund is not insolvent or rendered insolvent as a result of the withdrawal.

Paragraph 3.36

16. A trustee should be able to withdraw moneys from a trust fund to discharge a loan to the extent that the lender's money was used by the trustee to pay in whole or part for work done or materials incorporated into an improvement.

Paragraph 3.37

17. Where a beneficiary is liable to pay the trustee for outstanding debts, claims or damages, the trustee should be a beneficiary of the trust for any set-off or counterclaim relating to the performance of the contract with the same ranking as other beneficiaries of the trust. However, the sum which can be paid to the creditor beneficiary for a set-off or counterclaim from the trust fund should not have the effect of reducing the sum available for distribution to the other beneficiaries of the trust. That is, the sum available to meet the creditor beneficiary's set-off or counterclaim against the trustee as a beneficiary of the trust should be confined to the sum that the beneficiary is entitled to receive from the trust after the payment of the other beneficiaries of the trust such as the trustee's subcontractors and suppliers

Paragraphs 3.38-3.41

Distribution of trust funds to the beneficiaries

18. Where a trust fund is solvent, the trustee should be allowed to make payments to beneficiaries of the trust as they fall due.

Paragraph 3.46

Distribution of trust funds to the beneficiaries if the trust fund is insolvent

19. Where the trust fund is insolvent so that there are insufficient funds to satisfy the claims of all the beneficiaries of the trust, the trust funds should be distributed amongst the trust's beneficiaries on a pro rata basis.

Paragraph 3.47

Priority as between trust beneficiaries and a judgment creditor who has obtained an attachment order

20. Where money owing to a contractor on account of the contract price for a project would, if paid to the contractor, be subject to a trust, the money should not be subject to attachment. The attachment order should instead apply to the money the trustee is entitled to receive from the trust once its obligations to beneficiaries of the trust have been satisfied.

Paragraph 3.48

Information and training as to trust obligations

21. A training course should be developed dealing with the obligations and requirements for maintaining and operating a trust account.

Paragraph 3.51

No special limitation period should be provided for the enforcement of the trust scheme

22. Consistent with its recommendations in its report *Limitation and Notice of Actions*, no special limitation period should be provided for actions relating to the trust scheme recommended by the Commission in this report.

Paragraph 3.52

Disputes relating to the trust

23. Should provision be made for the trust scheme recommended in this report, any person who has an interest in any trust property and is aggrieved by any act, omission or decision of a trustee should be able to apply to the Supreme Court to review the act, omission or decision or to give directions in respect of any apprehended act, omission or decision.

Paragraph 3.53

Measures to promote the effectiveness of a trust scheme

24. Failure to comply with a trust scheme should be a ground for disciplinary action against a builder. To ensure that individuals cannot hide behind the veil of a partnership, company or other body corporate, if the registration of a partnership or a company or other body corporate is revoked, a finding should be made as to which individuals associated with the partnership or corporate body were responsible for the failure to comply with the trust scheme. If they are registered under the *Builders' Registration Act 1939*, that registration should be revoked as should the registration of any other partnership, company or other body corporate of which they are a partner, director or member of the board of management.

Paragraph 3.54

25. The Builders' Registration Board should be given power to appoint and authorize an accountant who is registered as an auditor to examine the books of account and records relating to any trust account of a participant in the industry and to furnish the Board with a confidential report on the matter and things disclosed by the examination.

Paragraph 3.55

26. Where a trustee is a corporation or other body corporate, every director, officer, employee, agent or other person having effective control of the corporation or body corporate and who is responsible for a breach of trust should be liable for the breach.

Paragraph 3.56

PAYMENT BONDING

Use of a bond as an alternative to a trust scheme

27. Payment bonds should be available as an alternative to the trust scheme. In any event those building their own home should not be required to obtain a bond to protect head contractors.

Paragraphs 3.60-3.61

Notification of default in an insurance policy

28. Where an owner, head contractor or subcontractor defaults on its insurance policy, the insurance company should be required to notify those covered by the bond of the default by giving notice of the default by an advertisement in the public notice section of a newspaper circulating in the State.

Paragraph 3.65

Time limitations on claims

29. Consistent with its view in the report on *Limitation and Notice of Actions* that there should be a uniform approach to all causes of action, claims under a bond should be

subject to a three year discovery period and an ultimate 15 year period. In the meantime, to provide some protection for sureties against claims by unknown subcontractors, a special time limit of three years from the final settlement or abandonment of the contract should be provided as the period within which a subcontractor could make a claim on a bond.

Paragraph 3.66

Distribution of proceeds

30. Where the proceeds of a bond are insufficient to satisfy all claims on it, the proceeds of the bond should be distributed on a pro rata basis.

Paragraph 3.67

Inspection of a bond

31. An interested parties should have a right to inspect a bond at the business address of the owner or contractor which has taken out the bond.

Paragraph 3.68

MANAGED CONTRACTS WITH DIRECT PAYMENT

32. Managed contracts with direct payment should not be introduced statutorily.

Paragraph 3.71

COVENANTING

33. Covenanting should not be introduced statutorily.

Paragraph 3.73

IMPLIED CONDITIONS

Proof of payment clauses

34. Proof of payment clauses should not be implied statutorily in all relevant contracts.

Paragraph 3. 79

35. Pay if paid clauses should be made void.

Paragraph 3.80

36. Pay when paid clauses should not be made void.

Paragraph 3.81

Proof of funding

37. Proof of funding clauses should not be implied statutorily in all relevant contracts.

Paragraph 3.83

"Romalpa" or retention of title clauses

38. A retention of title clause should be implied in all relevant contracts.

Paragraph 3.86

Assignment of progress payments

39. It should not be implied statutorily that there should be direct payment from the financier to the head contractor upon receipt by the financier of a progress certificate.

Paragraph 3.87

Payment of liquidated damages

40. It should statutorily be made an implied condition in contracts in the building and construction industry that no party in the contractual process should be liable for more than the cost of the consequences of its actions.

Paragraph 3.88

Suspension of works

41. All contracts in the building and construction industry should contain a right to suspend the work for failure to make payment, with a further right to terminate the contract if non-payment continues.

Paragraph 3.89

Retention funds

42. A party to a contract in the building and construction industry holding security in the form of cash or retention should be deemed to hold those monies in trust.

Paragraph 3.91

43. A contractor or subcontractor should be entitled statutorily to provide some other form of security such as bonds or an unconditional undertaking given by an approved financial institution or insurance company in lieu of cash or retention monies.

Paragraph 3.91

44. A contractor or subcontractor from whom the money is withheld should receive any interest paid on the money held in trust.

Paragraph 3.91

Payment terms

45. It should be provided statutorily that there should be an implied term of a maximum period for the payment of participants in the industry of 30 days and there should be realistic interest rates on late payments.

Paragraph 3.92

INSURANCE

46. A compulsory insurance scheme should not be introduced.

Paragraph 3.97

STOP NOTICE

47. A stop notice scheme should not be introduced.

Paragraph 3.100

HOLDBACK FUND

48. A holdback scheme should not be introduced.

Paragraph 3.102

GRADING OR LICENSING OF BUILDERS

49. While the Commission does not oppose providing more stringent criteria for licensing as a builder or grading builders or improving the education of builders, the Commission does not recommend that more stringent criteria or that the grading of builders be introduced as a means of dealing with the matters raised by the Commission's terms of reference.

Paragraph 3.110

R E COCK

W S MARTIN

R L SIMMONDS

24 March 1998

Appendix I
LIST OF THOSE WHO MADE A SUBMISSION¹

Air Conditioning & Mechanical Contractors' Association of Western Australia (Inc)
Association of Wall & Ceiling Contractors of South Australia
Australian Society of CPA's Centre of Excellence for Insolvency and Reconstruction
Building Owners and Managers' Association (now called Property Council of Australia)
M J Carbone
Clay Brick Manufacturers Association of Western Australia
R Cohen
Electrical Contractors Association of W A (Inc)
D A Forrester
Gillard Builders (1977) Pty Ltd
P Herkess
GFWA
Housing Industry Association Ltd (WA Division)
Housing Subcontractors Union
C Krishnan
The Master Painters, Decorators & Signwriters' Association of Western Australia
The Master Plumbers & Mechanical Services Association of Western Australia
New South Wales Security of Payment Committee
M Palmer
D Perkins
Southern Cross Electrical Engineering Pty Ltd
D Standen
P Steers
Western Power Corporation
J Wieske

¹ Six commentators who requested confidentiality or anonymity have not been included in this list.