



**JOINT STANDING COMMITTEE ON
SMALL BUSINESS**

DISCUSSION PAPER

**Security of Payment
in the
New South Wales Building Industry**

AUGUST 1998

This paper was prepared and published by:

Joint Standing Committee on Small Business
Parliament House
Macquarie Street
Sydney New South Wales 2000

Phone: (02) 9230 3054

Fax: (02) 9230 3052

Address for written submissions:

**Joint Standing Committee on Small Business
Parliament House
Macquarie Street
Sydney New South Wales 2000**

Written submissions should be delivered no later than Monday 7th September 1998.
Submissions may also be delivered by facsimile to (02) 9230 3052.

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Glossary

<i>Adjudication</i>	The process by which disputes between parties are resolved.
<i>Adjudication Order</i>	An order given by an adjudicator within seven days of appointment.
<i>Adjudicator</i>	An accredited person appointed by the BR/LA to adjudicate a dispute
<i>Attachment Order</i>	An order issued by the Court on application by the claimant that the party retain the sum of money nominated or be liable for its future payment.
<i>BR/LA</i>	Building Registration/Licensing Authority Would be established under the new legislation. Administering the registration of all commercial, industrial and residential building contractors.
<i>Client</i>	Owner of property or project giving rise to building work.
<i>Complex Adjudication</i>	Third tier in proposed sessional structure of adjudication
<i>CRIS</i>	Contractor Registration Information System
<i>DTA</i>	Designated Trust Account
<i>Head Contractor</i>	Contractor with a single contract with the client for all building work on one site.
<i>Intermediate Adjudication</i>	Second tier in proposed sessional structure of adjudication
<i>MSPI</i>	Mandatory Security of Payment Insurance
<i>Notices</i>	Notice of Intent to Revise Payment Notice requiring Adjudication Notice to Suspend Work Notice of Intent to Litigate
<i>Notification</i>	Serving of a Notice
<i>Principal</i>	1) Owner of unincorporated contracting business 2) Representative of client
<i>Standard Adjudication</i>	First tier in proposed sessional structure of adjudication
<i>the "Code"</i>	Building Code of Conduct A Code established under new legislation which would require all registered contractors to utilise written contracts which would include mandatory clauses governing notifications, adjudication and utilisation of designated trust accounts.

Foreword

Security of payment for subcontractors in the building industry has long been a concern of Government and the industry. Over the past decade, there have been many reports written on security of payments and the state of the building industry in New South Wales. Yet the problem of security of payment remains.

The Joint Standing Committee on Small Business decided to investigate the issue following continued reports of subcontractor difficulties in securing payment when head contractors became insolvent and in receiving prompt payment for labour and materials supplied.

Much of the Committee's early discussions focussed on a proposal put forward by the Construction Payments Group for legislation establishing a regime of cascading deemed trusts. Despite extended consideration of the proposal, the Committee was of the opinion that deemed trusts did not have the level of consensus required for the successful reform of the payment culture in the building industry.

As part of the process of consideration, the Committee gathered a significant volume of legal and professional opinions on this proposal. These documents have been collated into a background paper titled Deemed Trusts: The Full Debate.

Having reviewed all the legal opinions as to the viability of the deemed trust proposal, the Committee determined that totally different options of reform needed to be explored. This Discussion Paper is the culmination of the Committee's investigation of these options.

The Security of Payment Model outlined in this paper addresses many issues central to changing payment behaviour in the building industry. The Discussion Model combines a number of regulatory and contractual reforms which have received broad support from all sectors of the industry. It proposes a streamlining of dispute resolution in the industry through a legislated mandatory Building Code of Conduct. It further proposes that a mandatory Security of Payment insurance regime be introduced after the other reforms have had an opportunity to change industry behaviour and this insurance regime be phased in over a period of a further two years.

At the launch of Construct New South Wales on the 20th July 1998 The Hon Ron Dyer, MLC, Minister for Public Works and Services reiterated the Government's commitment to examine possible remedies to this situation and to examining any options identified by this Committee.

During the course of the inquiry, the Committee held extensive consultations with representatives from all sectors of the building industry. In addition, the Committee consulted with, and sought the advice of, NSW Government Departments, financial institutions and the insurance industry.

On behalf of the Committee, I would like to acknowledge all those who have contributed to the creation of this Discussion Paper and thank them for their valuable comment and expert advice.

Finally, I would like to encourage all sections of the building industry and the general public to consider the Discussion Model and to forward any comments or suggestions regarding the model's operation to the Committee Secretariat.



The Hon Edward M Obeid OAM MLC
Chairman

1. Introduction

The Joint Standing Committee on Small Business was established on the 27th November 1996, to inquire into issues affecting small business in New South Wales. The then Minister for State and Regional Development, the Hon Carl Scully MP stated that the Committee would:

“have a brief to listen to the concerns of the small business sector and make recommendations to guide its future growth...” and “...enable the Government to become more attuned to the needs and problems of the dynamic small business sector.”¹

1.1 Terms of Reference of the Committee

The Terms of Reference of the Joint Standing Committee upon Small Business are:

“That notwithstanding anything in the Standing Orders of both Houses, a Joint Standing Committee be appointed to inquire into and report upon Small Business in NSW with the following terms of reference:

- (1) The functions of the Committee are to report to Parliament on:
 - (a) matters which reflect the importance of small business to the economy;
 - (b) the streamlining of the provision of services to small business;
 - (c) the reduction of regulatory control over small businesses;
 - (d) the creation of employment opportunities within the small business industry;
 - (e) the provision of assistance to small businesses in niche marketing;
 - (f) the provision of assistance in the promotion of small business in regional development;
 - (g) the provision of assistance to small business to become internationally competitive;
 - (h) the provision of advice to persons intending to start a new business and to new starters in small business; and
 - (i) any matters relating to or arising out of the above terms of reference.

¹LA Hansard Articles 51st Parliament, pg 6355

- (2) The Committee is to consist of nine Members of both Houses, three being members of the Legislative Council (one supporting the Government, one Opposition and one Independent) and six being members of the Legislative Assembly (four members supporting the Government, one Opposition, one Independent and in the event that an Independent member is unavailable to serve on the Committee a member of the Opposition will be nominated instead). Members will be nominated in writing to the respective Clerks of the House.
- (3) The quorum of the Committee is five Members, provided that the Committee meet as a joint committee at all times.
- (4) The Chairman shall be a supporter of the Government.
- (5) The Chairman or any Acting Chairman has a deliberative vote and, in the event of an equality of votes, a casting vote.
- (6) The Committee has leave to sit during the sittings or any adjournment of either or both Houses, to adjourn from place to place; and to make visits of inspection within Australia and overseas."

The Committee members are:

Legislative Assembly

Mr J. Hunter	ALP
Ms R.P. Meagher	ALP
The Hon. J.J. Schipp	Liberal
Mr J.G. Tripodi	ALP
Mr J.A. Watkins	ALP
Mr A.H. Windsor	Independent

Legislative Council

The Hon. R.S. Jones	Independent
The Hon. R.S. Kersten	National
The Hon. E.M. Obeid	ALP (Chairman)

1.2 Definition of Small Business

Small businesses range from companies which operate on the international markets to self-employed people doing a few hours of word processing, family retailers, well established small manufacturers, rural and farm businesses, and franchises and agencies with varying levels of technical and marketing sophistication.

At a meeting held on the 22 April, 1997, the Committee agreed to adopt the following definition of small business:

1. Managerial Characteristics:

- they are independently owned and operated
- they are closely controlled by owner/managers who also contribute most, if not all, operating capital; and
- the principle decision making function rests with the owner/manager.

2. Size component:

- any size component should only serve as a functional addition to classification, rather than being of primary importance.

2. Context of the Inquiry

Security of payments for subcontractors in the construction industry has long been an issue of concern in New South Wales (NSW). The *Contractors' Debtors Act 1897* was introduced during the early days of the construction of railways in NSW in response to the problem of persons working on the railways not being paid wages due.

Data gathered by the Australian Bureau of Statistics creates a profile of the construction industry in New South Wales. In 1994-95, non-employing businesses accounted for 29,900 or 65% of all businesses in the construction industry. Small businesses with up to nine employees accounted for 14,500 or 31% of all businesses. This meant that while medium/large businesses accounted for 1,800 or 4% of the construction industry, the majority (96%) were classified as small.²

It has been the representatives of groups of subcontractors, suppliers and other service providers from this small business population, who have been advocating the need for a change in payment culture within the building industry over the past decade.

In May 1998, the *Contractors' Debtors Act 1897* was repealed and replaced by the *Contractors Debts Act 1997* to enable subcontractors to recover debts owed to them for work carried out and materials supplied by them. On its own, this Act is not intended to resolve all the problems of security of payment in the building industry. Rather, it is simply intended to be one of a number of measures that the Government is developing to address this complex problem.

It has been argued by representatives of subcontractor groups and associations that the *Contractors Debts Act 1997* does not resolve the main impediments to achieving security of payment. That is, the extensive cost and length of time that a court-based solution imposes on subcontractors and the failure of the Act to ensure timely payments.

In response to this concern, subcontractor groups have put forward a number of options which have been analysed and refined over time but not acted upon. In more recent times, subcontractor groups have expressed their preference for a proposal for legislation establishing deemed cascading trusts through the contractor chain. This is described further in Section 3.

Over the past five years, a number of reports into security of payments have been commissioned by Government departments. These reports include:

- *Feasibility Study into the Proposal Prepared by the NSW Security of Payment Committee*, Anderson Consulting, May 1993.
- *Independent Assessment of the Viability of the NSW Security of Payment Proposal*, Coopers & Lybrand Consultants, August 1996.

² ABS: *Survey of Employment and Earnings*; 1995/96.

- *Improving Security of Payment in the Building and Construction Industry*, Price Waterhouse, August 1996.
- *Security of Payment for Subcontractors, Consultants and Suppliers in the New South Wales Construction Industry*, Department of Public Works and Services, October 1996.

During the course of this inquiry, the Committee has been disturbed to discover that despite the extensive amount of time and thought spent on this issue, there is little statistical information about the extent of the security of payment problems in the construction industry.

2.1 The Inquiry Process

Since October 1997, the Committee has adopted a comprehensive process of inquiry into the security of payments for subcontractors in the building industry.

Initially, the Committee held briefings with representatives of contractor and subcontractor organisations in order to become familiar with all aspects of the security of payments debate. At this time it was decided that it would be appropriate for the Committee to facilitate a Round Table Discussion between the main organisations involved in the building industry.

Between November 1997 and March 1998, the Committee held three Round Table Discussions attended by representatives of:

- Attorney General's Department;
- Australian Bankers Association;
- Australian Constructors Association;
- Australian Securities Commission;
- Building Industry Specialist Contractors Organisation;
- Construction Payments Group;
- Construction Policy Steering Committee;
- Department of Public Works and Services;
- Master Builders Association;
- Master Plumbers Association;
- National Electrical Contractors Association;
- NSW Security of Payments Committee; and
- Property Council of Australia.

The primary purpose behind the Round Table Discussions was to encourage agreement between all parties for the need to change the culture of delayed or non-payment of monies in the construction industry and develop a consensus on how that could be achieved.

The Committee then asked participants for submissions on measures which would improve payment performance. A Working Party was elected from the participants at the Round Tables and this group assisted with the assessment and screening of the proposals submitted.

3. Deemed Trust Proposal

The NSW Security of Payments Committee (SOPC) was formed by organisations associated with the building industry to develop and promote an industry solution to the security of payment problem.

The SOPC proposed a concept of cascading deemed trusts through the contractor chain. Since the early 1990s this proposal has been developed and promoted to a succession of Governments and Government agencies.

In 1993, at the instigation of the NSW Department of Industrial Relations, Employment, Training and Further Education, the deemed trust proposal was examined in detail in what is now referred to as the Andersen Report.

The Andersen Report advised against the introduction of deemed trusts into the building industry and recommended a series of alternative initiatives which addressed other elements of the security of payment problem.

The SOPC has maintained that the arguments expressed in the Anderson Report are flawed and in the intervening years it has made a number of submissions which it believes counter objections raised to the proposal. In the process the SOPC also refined its proposal and sought further support for its position.

During the initial briefings, the SOPC and the Construction Payments Group (CPG) submitted these views to the Committee. These groups expressed their belief that the progressive refinement of the deemed trust proposal now satisfied the majority of concerns expressed by those organisations which had previously opposed a trust-based solution.

In December 1997, the CPG provided the Committee with a draft amendment to the *Contractors Debts Bill* which outlined how deemed trusts could be introduced into legislation.

The divisiveness of this proposal was apparent in discussions at a number of Working Party meetings held in 1998. Support for the deemed trust proposal was far from universal and the Committee was confronted with contrasting legal opinions as to the possible implications of the proposed legislative amendment.

Due to the diametrically opposed views held by participants, the Committee sought independent advice from the Crown Solicitors Office and the Institute of Chartered Accountants as to the likelihood of the deemed trust legislative amendments achieving security of payment in the building industry.

The full text of documents received by the Committee during this inquiry have been collated in a background paper titled *Deemed Trusts : The Full Debate*. This background paper has been prepared for simultaneous release.

In the absence of industry consensus concerning a trust based solution, the Committee proceeded with the construction of a Discussion Model for consideration by the building industry and the public.

The Discussion Model has drawn upon ideas which have emerged during the course of the Committee's inquiries. These ideas have focussed particularly on the proposed security of payment reforms in Queensland and on three items of recent legislation introduced in the United Kingdom under the broad title of Construction Contracts Legislation.

4. Summary of the Discussion Model

The Discussion Model aims to improve payment performance and security of payments in the building and construction industry.

The Discussion Model is the result of extensive consultations with industry representatives. Key features of the Discussion Model include:

- a new Building Registration/Licensing Authority (BR/LA);
- compulsory registration for all contractors;
- a Building Code of Conduct;
- dispute resolution and adjudication procedures; and
- mandatory security of payment insurance (MSPI).

If the Discussion Model were to be adopted it would necessitate the introduction of new legislation, the amendment of existing legislation, and the use of existing resources and new dispute resolution mechanisms and procedures. Envisaged changes are outlined below.

4.1 Legislative Provisions

New Legislation

- Establish a Building Registration/Licensing Authority (BR/LA) for all building contractors.
- Establish a Building Code of Conduct for registered contractors.
- Require that contracts be in writing and contain certain provisions.
- Require contractors to take out Mandatory Security of Payment Insurance (MSPI).

Amendments to Legislation

- Amend the *Contractors Debts Act 1997* to extend the utilisation of attachment orders.
- Amend the *Commercial Tribunal Act 1984*, enabling the tribunal to hear matters relating to prosecutions under the new Act and Code.

4.2 Building Registration/Licensing Authority

The proposed Building Registration/Licensing Authority would be responsible for:

- registration of building contractors;
- prosecuting breaches of the Act and Code;
- monitoring compliance; and
- accrediting dispute resolution bodies and adjudicators.

4.3 Features of the Building Code of Conduct

It is proposed that a Building Code of Conduct "The Code" for contractors be introduced which would require:

- that all contracts be written and contain certain features;
- that contractors notify subcontractors of intention to revise payment;
- that the BR/LA be notified of disputes;
- that a prescribed dispute resolution process be adopted;
- that a designated trust account (DTA) be established to keep disputed monies while the dispute is settled; and
- that all parties abide by the adjudicators' decisions.

The Code would also specify standard conditions for payment, notification and dispute resolution in the event that these were omitted from the written contract

4.4 Standard Contract Requirements

It is proposed that all contracts include the following features:

- a clear statement of scope of work to be performed;
- details of payment and notification terms;
- dispute resolution and adjudication provisions; and
- the right to suspend work in three specified circumstances.

It is proposed that contracts preclude:

- 'pay if paid' and 'pay when paid' provisions; and
- contracting out.

If payment, notification, adjudication and suspension of work clauses are not specified in the written contract, the standard requirements in the Code will be applied.

4.5 Adjudication

Under the requirements of the Building Code of Conduct all contracts will require the inclusion of a mandatory clause specifying that any party to a contract may refer a dispute to adjudication.

The lodging of a claim with the Small Claims Division (SCD) of the Local Court will be accepted as fulfilling the mandatory requirements of the adjudication process to settle disputes within its jurisdiction. This is currently \$3,000 but the Committee will recommend an increase to \$10,000. For disputes in excess of the SCD's jurisdiction, the adjudication will be a condition precedent or prior option to the enlivening of any other dispute resolution clauses or litigation.

An impartial accredited adjudicator will be appointed by the President of one of the professional associations accredited by the BR/LA and will provide the disputing parties with an adjudication order within seven days of appointment.

The order is to be based on:

- information provided about the dispute,
- conditions set out in the contract between the disputing parties, and
- any further material considered relevant to the resolution of the dispute.

If the adjudicator is unable to resolve the dispute within the seven days, an order is to be issued specifying the amount of money which must be placed into a designated trust pending the resolution of the dispute.

4.6 Designated Trust Account

All monies in dispute are to be lodged into a Designated Trust Account (DTA) subject to:

- all monies being due and payable under the conditions of contract;
- the adjudicator specifies the amount to be paid or placed in trust.

In the event that either party notifies their intent to litigate or proceed to utilise other dispute resolution clauses in the contract, all monies ordered for payment by the adjudicator are to be placed immediately into the DTA as a prerequisite to proceeding. The monies will remain in trust until the conclusion of the litigation or dispute resolution. Payments from the DTA will be made in accordance with the orders issued.

4.7 Mandatory Security of Payment Insurance

All registered contractors will be required to take out Mandatory Security of Payment Insurance (MSPI) to guarantee the payment of all parties who have a contract for building work on a site including subcontractors, material suppliers and other service providers in the event of contractor insolvency. This will provide added assurance for continuity of payments to the employees of all organisations.

Introduction of the MSPI would be deferred for a maximum of twelve months pending the implementation of other measures in this Discussion Model. MSPI would then be phased in over a period of a further two years.

4.8 Extending Existing Resources

- The Small Claims Division of the Local Court is to be used to settle disputes within its jurisdiction. This is currently \$3,000 but the Committee will recommend an increase to \$10,000.
- Department of Fair Trading Residential Building Licencing database is to be utilised as the basis of the Contractor Registration Information System (CRIS).
- The results of adjudication decisions will not limit the rights of parties to resolve their dispute by litigation and consequently lodge statements of claim in any court of competent jurisdiction or to utilise any provisions for alternative dispute resolutions in the contract.

5. Explanation of the Discussion Model

(Refer to Figure 1: Outline of the Discussion Model)

5.1 Legislative Provisions

The Discussion Model proposes that new legislative provisions would establish the following initiatives:

- a Building Registration/Licensing Authority for all individuals/entities contracting on a building site.
- a Building Code of Conduct.
- all contracts to be written and include provisions for payment, notification, adjudication and trust operation.
- mandatory security of payment insurance.

Use of the NSW Court System

The Discussion Model envisages the utilisation of the Small Claims Division of the Local Court for disputed claims for monies up to \$3,000. The Small Claims Division provides resolution of civil disputes without formal court proceedings or legal representatives. undefended claims result in a judgement within 28 days. Defended action depends on court lists but averages four to six weeks. The court order is final. With court facilities in 161 locations this avenue provides a cost-effective and accessible remedy for small disputes.

The Discussion Model proposes that the threshold in the Small Claims Division of \$3,000 be extended to \$10,000.

Either party may exercise their right to use the adjudication dispute resolution provisions and seek an order for an accredited independent adjudicator, appointed by the president of an accredited nominating body. This right will apply to disputes of any magnitude and will be the only initial option for disputes exceeding the Small Claims Division's jurisdictional limit.

The Discussion Model proposes that parties in dispute of claims over the Small Claims Division threshold have a first option to pursue adjudicated dispute resolution.

Parties who are aggrieved by an adjudicator's decision retain the right to litigate the case in a court of appropriate jurisdiction.

The Contractors Debts Act and Attachment Orders

Currently under the *Contractors Debts Act 1997*, an unpaid contractor has an option to request an attachment order against another person (normally the principal) at the commencement of court proceedings. An attachment order acts to secure any available monies until a claim is heard and judgement given. The attachment order facility is available on disputes of any magnitude.

The Discussion Model proposes an amendment to the *Contractors Debts Act 1997* providing subcontractors with a similar option for an attachment order to be made against a contractor.

A registered contractor having received an attachment order would be required to place the monies subject to the attachment order into a DTA. It would have the same effect as an order from the adjudicator.

The *Contractors Debts Act* provides for representations to the relevant court to have attachment orders varied or withdrawn.

The Commercial Tribunal

It is envisaged that all prosecutions for breaches of the Building Code of Conduct and all appeals against the registration decisions of the Building Registration/Licensing Authority would be heard in the Commercial Tribunal or its successor bodies.

The new legislation would give the Commercial Tribunal responsibility for hearing the BR/LA's prosecutions of individuals/entities which have breached the Code sufficiently to warrant penalties, disqualification or deregistration.

The Department of Fair Trading has advised the Committee of planned legislative changes to the operations of a number of tribunals including the Commercial Tribunal. To facilitate the changes envisaged in the Discussion Model, there may be a need to further amend the Commercial Tribunal Act 1984 or its succeeding legislation.

5.2 Building Registration/Licensing Authority (BR/LA)

(Refer to Figure 2: Outline of the Authority's Role)

In the Discussion Model, an Act would be passed establishing a BR/LA which would register all building contractors in NSW. The BR/LA would be responsible for the implementation of a Code and ensure that industry members comply with its requirements.

Registration

All contractors (and in certain instances owners and project managers) who are engaged in contracts in commercial and industrial building will be required to register with the BR/LA. Building and trade contractors already licensed by the Department of Fair Trading for residential building work would be registered automatically with the BR/LA. The scope of registration would seek to harmonise with the existing scope of licensing in Queensland.

The names and details of principals, directors, executive officers and managers of contractors would be recorded by the BR/LA on a register in the Contractor Registration Information System (CRIS).

Contractors solely engaged in civil works (eg. roads, dams, bridges etc.) will not be required to register with the BR/LA.

The BR/LA would be responsible for vetting applications for registrations and registration renewals.

Compliance with the Act and the Building Code of Conduct

The BR/LA would administer a Code for all registered contracting entities and would be responsible for investigating and prosecuting unregistered contractors and registered contractors who operated in breach of the Act or the Code.

Disciplinary actions may include formal warnings, fines, prosecutions, temporary suspension and permanent deregistrations for major or consistent breaches of the Code.

Adjudication

The BR/LA would be responsible for the development and maintenance of an accredited network of appropriately qualified adjudicators and accredited professional bodies and institutes, which nominate accredited adjudicators from their membership.

The BR/LA would not adjudicate disputes but would refer parties in dispute to accredited bodies or institutes which would appoint an adjudicator. The decision of the adjudicator would be required within seven days. Both parties would be required to comply with the decision of the adjudicator. The adjudicator would be required to provide his or her decision to both parties in writing and to provide a copy to the BR/LA nominating if there was any breach of the Act or Code.

Owners, Principals and Investors

Owners, principals and investors who concurrently enter contracts with more than one contractor for the completion of building work on a site which they own or lease will be required to register on the first occasion they enter such contracts.

There will be no requirement to register if the only contract signed is with a registered contractor to fulfill the role of head contractor for all of the building work on the site.

Project managers who contract with owners, principals or investors for the management of building contracts between those parties and other registered building contractors will also be required to register with the BR/LA.

Owner-builders undertaking residential building work under an owner-builder permit issued by the Department of Fair Trading will be considered as registered automatically by the issue of the owner-builder permit. Contracts between such registered owners, principals, investors, owner-builders and the registered building contractors will be subject to the provision of the Code.

Breaches of the Act

The BR/LA would be responsible for monitoring compliance with the legislation and the Code and for prosecution of entities for non-compliance.

Contractors would be in breach of the Act if they entered into building contracts while unregistered. Legislation would provide for sanctions ranging from formal warnings for a first offence to prosecution in the Local Court with penalties of up to 100 points (currently \$11,000) per offence for repeat offenders.

If a person or entity was found to have repeatedly entered into contracts while unregistered, the legislation would give the BR/LA the power to prosecute for the disqualification of principals, directors and operational managers of the unregistered entity (and who are also principals, owners, directors and operational managers in a registered entity) from holding such office in a registered entity.

Powers of Investigation

The BR/LA would have the powers to:

- investigate any breach of the Code;
- require copies of all contractual arrangements;
- require certification from the principal or chief financial officer that the entity has the financial resources to pay its obligations as they become due and payable; and
- demand the provision of an independent financial assessment by a certified public accountant or external auditor of the entity's continuing financial viability.

In order to pursue investigations into breaches of the Code, the BR/LA would have the power to suspend for a period of up to 60 days the registration of any entity associated with the principals, directors and operational managers.

For the suspension of registration to continue beyond 60 days, the BR/LA would need to seek an order for disqualification against the entities in the Commercial Tribunal.

Power to Prosecute

After investigation, the BR/LA would be able to prosecute for breach of the Code in the Commercial Tribunal and seek penalties and disqualifications against individuals and associated entities.

Power to Decline an Application or Renewal

The BR/LA would have the power to decline an application for registration or application for renewal of a registration from any individual or entity who has an unsatisfactory record or any individual who has been a principal, director or operational manager of an entity with an unsatisfactory record.

Entities and individuals would have the right to appeal to the Commercial Tribunal against any BR/LA decision regarding their registration but not about any other entities' or individuals' registration.

5.3 Building Code of Conduct

Legislation establishing the BR/LA would refer to a mandatory Code for all registered building entities.

Registered contractors would be obliged to comply with the Code or face deregistration. Only registered contractors would be able to enter into contracts with principals and/or subcontractors for the purpose of building.

Suspension of registration would prevent the contractor from entering new contracts but would allow for the completion of any existing contracts.

The Code will specify the behaviour required of registered contractors in respect of contract documentation, payments, notifications and adjudication. The Code will also establish standard contract requirements which would be applied if they were not already contained in the contract.

Breaches of the Code

Breaches of the Code would include:

- contracting without a written document;
- making contracts that inadequately specifying the contractor and registration number;
- making contracts which include clauses which are voided by the Code;
- failure to provide notifications required by the Code;
- failure to respond to dispute notification;
- failure to attend dispute resolution;
- failure to deposit monies in dispute in a DTA;
- failure to comply with an adjudicator's decision; and
- claims which have been assessed to be vexatious by an adjudicator.

5.4 Standard Contract Requirements

One of the main objects of the Code would be to prescribe minimum standards for building industry contracts entered into by contractors and subcontractors.

The Code would set certain standard conditions for contracts which would be applied even if the contracting parties failed to include them. They include:

Payment terms: 14 days from date of invoice.

Notification terms: seven days from receipt of invoice or any subsequent notice.

Adjudication terms: an impartial adjudicator will be nominated by the president of an accredited body or institute and will arrange an adjudication and provide a decision within seven days of notification of the dispute.

Amounts in dispute: all amounts in dispute are to be deposited in the designated trust account from the time they become due and payable.

(Refer Figure 3: Document Flow During Notification)

Contracts will only be able to exceed the standard conditions (set out above) in respect to payment terms. Any contracts which include clauses to extend notification and adjudication time-frames will have such clauses declared void.

The Code would specify that 'pay if paid', 'pay when paid' and contracting out clauses included in a contract would be void, as would any clauses in contracts seeking to negate the intentions of the Code.

Contracts would have to include the following general provisions:

- the contractor's registration number;
- a clear statement of scope of work to be performed;
- the work completion date; and
- how much, how and when payment is to be made.

Contracts would also need to have the following provisions regarding adjudication:

- a requirement that disputes be subject to prompt impartial adjudication, including details of how disputes are to be resolved;
- a requirement that variations be recorded in writing and signed by both parties;
- a requirement that contractors notify subcontractors if payment is to be varied, delayed or withheld;
- a provision allowing subcontractors to notify of suspension of work if payment is withheld without notification of a dispute or if the contractor fails to comply with an adjudicator's decision;
- a requirement that all parties comply with the adjudicators' decisions (an adjudicator's decision may be subsequently tested in an appropriate court);
- a requirement that monies in dispute be held in a DTA from the time they are ordered by the adjudicator until the time a decision is made; and
- a requirement that monies are put into a DTA at the time notice is given that either party intends to litigate or utilise alternative dispute resolution.

The standard conditions of contract will recognise the subcontractor's right to issue a notice of intention to suspend work in the following circumstances:

- When the subcontractor receives incomplete payment without prior notice of intent to revise payment;
- When either party fails to comply with the adjudicator's order; and
- When insolvency proceedings commence against either party.

Suspension of work can only occur at the expiry of the notice if the circumstances giving rise to the notice remain unchanged. In particular subcontractors are not entitled to suspend work if they have received notification of intent to litigate or pursue alternative dispute resolution options in the contract, together with evidence that any payment ordered by the adjudicator has been deposited in a DTA.

(Refer Figure 4: Suspension of Work)

5.5 Adjudication and Dispute Resolution

The Discussion Model does not propose to interfere with the normal commercial arrangements agreed between a contractor and subcontractor as to the terms of payment or alternative dispute resolution provisions.

Appointment and Standard Requirements

It is envisaged that the Code would require all written contracts to contain provisions for an adjudication process in the event of a dispute. If the written contract does not include provisions for adjudicated dispute resolution, or if the conditions of the Code are contravened, either party to the dispute may ask the BR/LA to refer the dispute for resolution under the standard conditions in the Code.

After the BR/LA has been notified of a dispute, the BR/LA would refer the parties in dispute to the president of an accredited institute or body who would appoint an adjudicator.

These arrangements would be subject to the following standard requirements:

- that the adjudicator be independent, accredited by the BR/LA and be a member of a body which is accredited by the BR/LA for nominating adjudicators;
- that the adjudicator nominating body is advised within seven days of the notice of intent to revise payment; and
- that the adjudicator provide a decision within seven days of being appointed.

Powers and Responsibilities of the Adjudicator

The adjudicator appointed would have the power to request all relevant contract documents from both parties and may take the initiative in ascertaining the facts and the law in order to resolve the dispute.

The adjudicator would act impartially and avoid incurring unnecessary expense. Expenses incurred and charges for the adjudicator's services would be met jointly by the parties to the dispute. To compensate innocent parties for exaggerated or vexatious claims or unnecessary delays to the adjudication process, the adjudicator would be empowered to vary the allocation of charges and award the cost of the adjudication against the party at fault.

Under the terms of the Code, the adjudicator is responsible for arranging an adjudication and

providing a decision from the initial session within seven days of being appointed. This decision could be final by ordering any monies which are due and payable to be paid.

The decision could also be interim or provisional by ordering an amount of disputed monies to be placed into a DTA and providing the parties with a written summary of the dispute, which could be used by the parties in pursuing litigation or other dispute resolution options in their contract.

If, at the end of the initial adjudication session there is no conclusive decision the parties to the dispute may opt to:

- continue with the adjudication process into a further session;
- utilise other dispute resolution processes in their contract (eg arbitration, expert determination or mediation);
- litigate in court; or
- agree on a mutually acceptable settlement.

The decision of the adjudicator will be provided to both parties in writing and a copy will be provided to the BR/LA. The decision will specify the amount and date of any payment ordered. It will also record any breaches of the Code discovered in the process of the adjudication and any variation to the allocation of charges for the adjudicator's services.

It is envisaged that there will be fee guidelines available to both parties, which will nominate a minimum and maximum schedule of charges for the first adjudication session. If the matter proceeds into further sessions, it will be the responsibility of the adjudicator to estimate the time and cost to complete the adjudication. It will be the responsibility of the parties to agree to any continuation and to be jointly responsible for the costs of further adjudication sessions.

(Refer to Figure 5: The Adjudication Process)

Compliance with Adjudicator's Decision

Decisions of the adjudicator are binding.

Any party aggrieved by the decision of an adjudicator retains the right to settle the matter by litigation or by utilising any alternative dispute resolution clauses in the contract. Notice of intent to litigate is to be provided within seven days of the adjudicator's decision and must be accompanied with evidence that the monies ordered to be paid by the adjudicator have been paid or lodged in a DTA.

The intention to litigate or utilise alternative dispute resolution clauses will not be considered grounds for not complying with a payment order. Monies ordered to be paid by the adjudicator are either paid as ordered or lodged in the DTA as a prerequisite until the result of the litigation is finalised.

Failure to abide by the adjudicator's decision by either party will be grounds for notification of the suspension of work.

Adjudicator Indemnity

The adjudicators and their nominating bodies need to be provided with security of payment and indemnity from litigation in respect of any negligence on their part. Adjudicators will, however, be liable for fraud.

It will also be necessary to include provisions which ensure adjudicators cannot be compelled to give evidence in any subsequent litigation or alternative dispute resolution processes.

5.6 Designated Trust Accounts (DTA)

(Refer Figure 6: Trust Account Operations)

All registered building contractors who use subcontractors and/or purchase building supplies will need to establish a Designated Trust Account for the lodgement of any monies in dispute.

Notification Requirements

On receipt of a notification from the contractor that a payment under the contract is to be revised delayed or withheld, the subcontractor has the option to issue a notice requiring adjudication.

During the first session the adjudicator must determine if any monies are due and payable. If the adjudicator is unable to issue a final decision, he or she must determine what monies must be lodged in the DTA until the matter is resolved by the adjudicator's final order, or by subsequent dispute resolution or litigation.

Following an adjudicator's decision, either party has seven days to issue a notice of intent to litigate. Any monies ordered paid by the adjudicator that have not been paid must be placed in the DTA at the time that notice is given as a prerequisite prior to proceeding with litigation or any other dispute resolution process.

In the event of a vexatious claim or an unreasonable basis for declining to make payment, the adjudicator is empowered to find either party to have acted in bad faith and record such a finding in their decision. Such a finding would be regarded as a breach of the Code and would be recorded by the BR/LA.

The registered building contractor, as trustee, is responsible for disbursements from the DTA in accordance with the payment orders issued by the adjudicator or subsequent dispute resolution.

The Code and Trustee Requirements

Any delay in depositing monies due and payable into the DTA without a proper basis for such

a delay will be considered an act of bad faith and as such, a breach of the Code.

Failure to comply with any payment orders issued by an adjudicator is a breach of the Code. The adjudicator will record any breaches of the Code in his/her decision.

5.7 Mandatory Security of Payment Insurance

(Refer Figure 7: Phased Introduction of MSPI)

All registered contractors will be required to take out Mandatory Security of Payment Insurance to guarantee the payment of subcontractors, suppliers and other service providers in the event of the contractor's insolvency. This would be a precondition to signing any building contract.

It is anticipated that the MSPI would initially be delayed during the implementation of other measures in this Discussion Model and be phased in over a period of a further two years. The MSPI would initially be introduced for contractors entering contracts exceeding \$5 million. The threshold would then be lowered to include contracts exceeding \$1 million before being extended to include all contracts.

The phased introduction of the MSPI would give the insurance industry time to develop appropriate products and premiums, and to give contractors time to determine the insurer's requirements and where necessary restructure their capital to meet projected requirements.

The minimum requirement for any insurance products would be set at the equivalent of a surety bond for a job specific contract guaranteeing payment of a minimum of 80% of the invoice value owed to subcontractors and material suppliers at the point of insolvency.

It is envisaged that insurers underwriting the MSPI will be approved by the relevant Minister. Both the Minister and the insurer would sign a protocol regarding the insurance products offered. Both parties would enter into information sharing protocols about the registration status and claim history of registered contractors, similar to those developed by the Department of Fair Trading regarding Home Warranty Insurance.

While Government work is subject to all the provisions of the Discussion Model, it is proposed that the Government, as the principal on a building project, would not be required to hold security of payment insurance. However, MSPI would be required for all other contractors in that contractual chain on a Government building project.

5.8 Future Developments

Credit Reference Bureau

The monitoring operations of the BR/LA could be expanded to include a full credit referencing service, which would gather and provide information service to the industry on all registered

entities' payment performance, as well as recording any breaches of the Code and adjudicator decisions.

Subscriber access by registered contractors to such a service would be very commercially valuable. Industry insurers could use the information to help them assess risk and set premiums.

Such a development would be an ideal service for contracting out to the private sector on the basis of tenders for periods not exceeding five years.

6. Discussion Issues

The release of this Discussion Paper can be viewed as the laying of the foundation stone upon which a solution to security of payment in the building industry can be constructed.

The Committee's consideration of security of payment issues has been comprehensive and included extensive analysis of the deemed trust proposal, proposed Queensland reforms and overseas legislation. In addition, the development of the Discussion Paper and Discussion Model has involved consultation with representatives of subcontractors, contractors, insurers, financial institutions and potential adjudicators.

In order for the Committee to gain constructive comments on whether the reforms outlined in the Discussion Model would achieve change in the building industry's payment behaviour, opinions must focus on the merit of this Discussion Model.

The Discussion Paper and associated Discussion Model should be viewed in this context.

6.1 Legislative Provisions

The Discussion Model proposes that a number of legislative provisions will need to be enacted prior to the implementation of any reforms. As established above, these provisions would be required to establish a Building Registration/Licensing Authority, a Building Code of Conduct, and mandatory subcontractor security insurance. At this preliminary stage, it appears that these legislative provisions would be enacted through a combination of amendments to existing acts and new legislation.

The Department of Public Works and Services has been responsible for the policy formation on Security of Payment for a number of years. It is envisaged that the Minister for Public Works and Services would be responsible for the introduction of new or amended legislation. Further, the Department would be tasked with implementing, administering and auspicing the legislation and overseeing any new agency such as the BR/LA.

Advice from the Attorney General's Department, Crown Solicitor's Office and the Parliamentary Counsel would be required in any legislative developments.

In order to assist in refinement of the Discussion Model the Committee believes that the following points could be addressed:

Discussion Points

- Is there any alternative to new legislation for the creation of Building Registration/Licensing Authority, a Building Code of Conduct, and mandatory subcontractor security insurance?
- How could such an alternative accommodate the Building Code of Conduct?

6.2 Building Registration/Licensing Authority

The Committee envisages that the BR/LA would operate as a co-ordinating body for the reforms outlined in the Discussion Model. The BR/LA would be responsible for registration of contractors; collation of dispute data; administration of the Code and administration of the adjudication network.

The Discussion Model proposes that contractors who currently hold Residential Building Licences would automatically be registered by the BR/LA. The need for a separate residential license would be removed.

The Committee anticipates that once established the BR/LA would function in a cost neutral capacity with registration fees covering operational costs.

In order to assist in refinement of the Discussion Model the Committee believes that the following points could be addressed:

Discussion Points

- Are there any other bodies which may be better suited to the collation of data relating to disputes than the proposed BR/LA?
- What level of disputation would warrant immediate investigation by the BR/LA?
- Should information about disputes and breaches of the Code by contractors be publicly available?

6.3 Building Code of Conduct

The introduction of a Code governing payment and notification behaviour in the building industry is directed specifically at eliminating slow payment and reducing the magnitude of insolvencies.

Dispute data and breaches of the Code collated by the BR/LA would be used to monitor behaviour and as a basis for decisions on disciplinary action and registration.

6.4 Standard Contract Requirements

The requirement for standard contract provisions in the Discussion Model is aimed at eliminating a number of previously acceptable payment clauses such as 'pay when paid' or 'pay if paid'. The elimination of these clauses would require a change in contractual arrangements for many contractors and subcontractors.

Despite the existence of standard contracts in the building industry, many contractual

arrangements are agreed without written confirmation and without proper consideration of the terms. This makes it difficult for parties in dispute to provide sufficient evidence in support of a claim regarding monies owed.

The Discussion Model proposes that all contracts will be written, as will all variations.

In order to assist in refinement of the Discussion Model the Committee believes that the following points could be addressed:

Discussion Points

- Will there be any unintended consequences from the elimination of “pay when paid” and “pay if paid” clauses? How can any adverse impact be minimised?
- What changes would elimination of these clauses require to the head contractor/principal contract?
- Should standard conditions be established by legislation to cover unwritten contracts?
- How can the industry convert to written contracts at all levels in the contractual chain?

6.5 Adjudication Process

The Discussion Model has adopted an adjudication regime broadly modelled on the recent United Kingdom legislation which introduced “The Scheme for Construction Contracts.”

Accreditation and availability

The Discussion Model proposes accreditation by the BR/LA of both nominating bodies and adjudicators. Independence of the adjudication function is provided by the professional bodies in two ways: they establish appropriate criteria for their members to qualify as accredited adjudicators and they provide an impartial process for checking for conflict of interest prior to nomination.

Preliminary discussions with professional bodies indicate there may be in excess of 2,000 potential adjudicators in NSW and that the bodies would be interested in participating in such a scheme.

Sessional Structure

This sessional structure would classify disputes into three categories: standard, intermediate, and complex. Fee levels would be commensurate with the time required to complete the adjudication. The following indicative description and fee guidelines emerged from discussions with professional bodies.

A standard adjudication requiring preparation, arrangement, a site meeting or hearing of one to two hours duration and confirmation of decision would incur a standard fee in the vicinity

of \$500. It is envisaged most single trade disputes (eg. quality of works dispute) would be settled at the standard level.

An intermediate adjudication requiring preparation, arrangement, site meeting or hearing taking up to six hours duration and confirmation of decision would incur an intermediate fee in the vicinity of \$1000. It is envisaged most multiple trade and contractual disputes would be settled at this intermediate level. It is proposed that the adjudicator would not go beyond this category of resolution without the approval of the parties to proceed.

Adjudication requiring more than six hours of site visit(s) and hearing time would be classified as a complex adjudication. An adjudication at this level may have unusual quality or contractual issues, which are not capable of resolution by direct inspection of the work or examination of the contract documentation.

In such instances, it would be necessary for the adjudicator to provide both parties with an estimate of the time anticipated and rate on which their fee would be based. It is envisaged that no monetary limit is placed on this category. It would be within the control of either party to the dispute to limit their expenditure when giving approval to proceed.

In complex adjudications, if either party does not agree to proceed the adjudicator will conclude the adjudication at the intermediate limit. The adjudication order will include instructions on what monies are to be deposited in a DTA, what alternative options the parties have for the subsequent resolution of their dispute and a summary of the position at which the adjudication was concluded.

Sanctions

The Discussion Model provides two sanctions for failure to comply with an adjudicator's decision. The first is the reporting of a breach of the Code and the second allows the other party to issue a notice of intention to suspend work.

In order to assist in refinement of the Discussion Model the Committee believes that the following points could be addressed:

Discussion Points

- Can professional bodies provide a sufficient number of adjudicators?
- What training in adjudication processes is required prior to accreditation?
- What guidelines should adjudicators apply for setting fees?
- Will disputing parties perceive value for money from adjudications costing between \$500 and \$1000?
- Should adjudication orders be given the option of enforcement, in the same manner as arbitration and tribunal orders by registration through a relevant court?

6.6 Designated Trust Account

The Discussion Model proposes that all registered building contractors who subcontract work or purchase building supplies establish a designated trust account. The trust would only be used for the lodgement of monies following an adjudication or receipt of an attachment order. Certification of the deposit would provide the subcontractor and the BR/LA with evidence that the contractor is not withholding monies because of liquidity problems.

The monies would remain in the trust until final resolution of the dispute when the trustee would be responsible for disbursements from the fund in accordance with the payment orders issued by the adjudicator or subsequent dispute resolution.

In order to assist in refinement of the Discussion Model the Committee believes that the following points could be addressed:

Discussion Points

- Should bank guarantees be considered as substitutes for monies in trust?

6.7 Mandatory Security of Payment Insurance

Mandatory insurance would provide a safety net for all parties who have a contract for building work on a site including subcontractors, material suppliers and services providers such as architects, engineers, and quantity surveyors.

While the Committee considered the inclusion of employees of the head contractor in the provisions of the Discussion Model it decided against this after considering the protection already afforded this group by industrial and bankruptcy law.

Reforms in the Discussion Model are designed to assist early identification of insolvency and so minimise the amount of money owed to creditors. This in turn would reduce the level of claims and ultimately the cost of premiums.

The Discussion Model, therefore, proposes a deferred commencement period during which the actuarial analysis can be undertaken and any change in contractors' financial structure and payment behaviour factored.

At this preliminary stage insurance companies have indicated an interest in a mandatory insurance scheme.

The industry's experience with Home Warranty Insurance confirms that many contractors are undercapitalised and would encounter difficulties in meeting insurers' solvency criteria. There is considerable synergy between Home Warranty Insurance and Subcontractor Security Insurance. It is purchased by the same client to protect different end customers. It is highly likely they will be sold together and as a consequence put pressure on the insurers' prudential

limits in the case of some large but poorly structured contractors.

The Discussion Model proposes that the requirement for insurance would be introduced over a 2 year period starting with contracts in excess of \$5 million and progressively extending to all contracts and contractors. While there was consensus regarding the delay to introduction, one insurer recommended immediate rather than phased introduction.

In order to assist in refinement of the Discussion Model the Committee believes that the following points could be addressed:

Discussion Points

- What type of insurance products can address the security of payment?
- How can undercapitalised contractors adjust to meet solvency requirements?
- What initiatives are required to facilitate the transformation required in capitalisation?
- Should full implementation of insurance be introduced after one year rather than phasing? Would such an introduction have start-up risks?
- Should insurance cover be extended to the death and/or the disappearance of the contractor?

6.8 The Client/Head Contractor Relationship

The Committee is most anxious to consider any extension of the Discussion Model which provides business with a better and more equitable business environment. The most important of these extensions would of necessity be the Client /Head Contractor relationship.

While the Committee's original focus was on improving the remainder of the construction chain, it will be glad to consider any suggestions which extend the promptness and security of payments at the first and very critical linkage.

Many of the component parts of the Discussion Model could well adapt to the head contract arrangement including:

- using the range of notices described in Figure 3;
- obtaining adjudicators for resolution of their dispute;
- putting monies in dispute into a trust; and
- being bound by the adjudicator's decision.

They would retain the right to settle disputes by ADR or litigation.

It is generally difficult to envisage clients being interested in registration and it is more difficult

to envisage an additional insurance obligation applying to the site.

In order to assist in refinement of the Discussion Model the Committee believes that the following points could be addressed:

Discussion Points

- Would the disputes between the client and the head contractor require a more specialised panel of adjudicators?
- Would the use of DTA's improve and expedite the resolution of these disputes?
- Would adjudication prove cost effective and reduce other forms of litigation?