JOINT STANDING COMMITTEE ON
SMALL BUSINESS

Security of Payment

Deemed Trusts: The Full Debate

August 1998

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Document 7 *Australian Bankers' Association*
Correspondence: 3 March 1998; 6 March 1998.

Document 8 *Philip Davenport* on behalf of the Construction Payment Group
Response to correspondence from the Australian Bankers' Association dated 3rd March.

Document 9 *Australian Finance Conference*
Correspondence: 5 March 1998.

Document 10 *Institute of Chartered Accountants*
Correspondence on amendments to the Contractors Debts Bill.

Document 11 *Advising from Crown Solicitor's Office*
Correspondence re: Legislative proposal for security of payments - building sub-contractors.

Foreword

Since October 1997 the Joint Standing Committee on Small Business has been working towards finding a solution to the security of payment problems in the building industry in New South Wales.

During the course of the inquiry, the Committee was able to gain the release of a number of reports on deemed trusts. Additionally, the Construction Payments Group provided the Committee with a substantial volume of reports and commentary on previous deemed trust proposals as well as a draft amendment of the Contractor Debts Act 1997 incorporating deemed trusts in legislation.

During its deliberations on this important issue, the Committee gave considerable attention to the proposal to introduce a system of cascading deemed trusts. This proposal was the focus of a number of meetings with key industry groups.

The opinions of participants can only be described as divided. It became clear that no consensus was going to be achieved on the specific proposal put forward by the Construction Payments Group and that there was no likelihood of agreement on any reform utilising a structure which included deemed trusts. This was apparent in the considerable amount of legal and professional opinion prepared by and distributed to forum participants.

As a result of the divided opinion of participants, the Committee felt it had no option but to seek independent legal and professional advice on the proposal.

The body of material that the Committee has collated is an important chapter in the continuing debate within the building industry as to the merits of deemed trusts. As such, the Joint Standing Committee on Small Business believes that it is in the interest of all concerned that these documents be made publicly available.

I believe that the release of these documents will clarify the inherent difficulties that the Committee grappled with when examining the deemed trust proposal.

Although the Committee has not been able to proceed with the deemed trust proposal, the concerted push for reform in the building industry has resulted in continued dialogue between contractor and subcontractor representatives as to how to best achieve security of payment in the building industry. The contribution of this dialogue can be seen in those reforms which have bipartisan support and which have been used as the basis for the Committee's **"Discussion Paper on Security of Payments in the Building Industry"**.

On behalf of the Committee, I would like to thank all those participants who have contributed to the security of payment inquiry. In particular, I wish to thank the Construction Payment Group, NSW Security of Payment Committee, Master Builder's Association, Australian Constructors Association, the Property Council of Australia, the Institute of Chartered Accountants and the Crown Solicitor's Office for the time and effort spent on analysis of the deemed trust proposal.

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.
>
> (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

[1] LA Hansard Articles 51st Parliament, pg 6355

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)**

2. Background

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.

This Act provided subcontractors and suppliers with a statutory regime for the recovery of wages and cost of materials supplied when a contractor fails to pay moneys owed. In recent years, however, a number of court rulings have restricted the applicability of the Act, making claims extremely difficult.

On the 4th May 1998, the *Contractors' Debtors Act 1897* was repealed and replaced by the *Contractors Debt Act 1997*. While substantially the same as the repealed 1897 Act, the 1997 Act aims to provide a number of measures to make it easier for persons to obtain payment of debts owed.

The *Contractors Debt Act 1997* includes the following provisions:

- a person may obtain a default judgement without the need for a formal hearing;
- the amount which a person can recover has been increased;
- an attachment order may be made against any person from whom the unpaid person may be able to recover the debt;
- the defaulting contractor is to provide an unpaid person with the name of any person(s) from whom they may be able to recover the debt. A penalty exists if this information is not provided;
- payment may be sought from any other person(s) associated with the defaulting contractor; and
- the limitation period for commencing proceedings has increased from 3 months to 12 months.

On its own, this Act is not intended to resolve all the problems of security of payment in the building industry. Rather, it is intended to be one of a number of measures that the Government is developing to address this complex problem.

Representatives of subcontractor groups and associations have, however, argued that the *Contractor Debts Act 1997* does not resolve the main impediments to achieving security of payment in the building industry. 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 continuing concern regarding the inability of the *Contractors Debt Act 1997* to adequately provide security of payment, subcontractor groups have lobbied for government to introduce measures to reduce the incidence of delayed, reduced and non payment of moneys owed to subcontractors and suppliers on building projects.

3. The Deemed Trust Debate

At the conclusion of the Royal Commission into Productivity in the Building Industry in NSW, participants in the industry were asked to develop a proposal which outlined how payments at all levels in the supply chain could be made more secure and timely. In November 1991, as a result of this request, the NSW Security of Payments Committee (a voluntary affiliation of bodies associated with the building industry) was formed.[2]

In December 1992, the NSW Security of Payments Committee (SOPC) promoted the concept of cascading deemed trusts through the contractor chain as a solution to the industry's security of payment problems. The core recommendations of the original proposal include:

- the creation by legislation of a deemed trusts scheme which would secure payments for subcontractors.
- a right of all parties to information to evidence that future payments are adequately provided for.
- a certification system and a shorter payment period.
- the development of procedures for enhanced alternative dispute resolution.

Since its inception, this proposal has received thorough consideration by a succession of State Governments and departments and has been the subject of a number of reports.

Following reports of difficulties experienced by subcontractors in securing prompt payment for labour and materials supplied, the Committee decided to hold an inquiry into security of payments in the building industry. As part of this process, key industry representatives were invited to attend a number of working party meetings between November 1997 and April 1998.

As a first step, 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 the commencement of these briefings, the SOPC and the Construction Payments Group (CPG)[3] reaffirmed their belief that the deemed trust proposal was the way to achieve secure and timely payments in the building industry.

The position put to the Committee by these groups was that continual refinement of their deemed trust proposal should satisfy all the concerns expressed by those opposing it and would provide security of payment and prompt payment to subcontractors.

---

[2] Coopers & Lybrand Consultants: *Independent Assessment of the Viability of the NSW Security of Payment Committee Proposal*; August 1996, p8.

[3] The Construction Payments Group was formed in 1996 as a voluntary affiliation of subcontractor (in particular plumbing and electrician) aligned bodies.

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.

In December 1997, the CPG provided the Committee with a draft amendment to the *Contractors Debts Bill 1997* which outlined how deemed trusts could be introduced into legislation. It should be noted that the original SOPC proposal is far more detailed than the draft amendment.

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.

The main criticism of the proposal centred on the cost of deemed trusts to participants in the building industry. In pure economic terms, it was questioned whether the benefit to industry participants would be greater than the cost of the initiative. The answer to this important question remains an unknown.

During the course of the inquiry, the Committee has received a number of documents which have assessed the workability of the deemed trust proposal. In addition, 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.

It is the Committee's belief that, it is in the interest of all concerned parties that these documents be made publicly available.

The list of documents released by the Committee are:

Document 1 *Construction Payment Group*
Submission for introduction of statutory trusts in the construction industry.

Document 2 *Construction Payment Group*
Proposed amendment to the Contractors Debts Bill.

Document 3 *Clayton Utz*
Comments on draft amendments to the Contractors Debts Bill relating to statutory trusts. This opinion was commissioned by the Australian Construction Association and the Property Council of Australia.

Document 4 *Coopers & Lybrand Consultants*
Independent assessment of the viability of the NSW Security of Payment Committee Proposal, August 1996. This report was commissioned by the Department of Public Works and Services.

Document 5 *Philip Davenport on behalf of the Construction Payment Group*
Response to Clayton Utz comments on draft amendment to the Contractors Debt Bills relating to statutory trusts.

Document 6 *Philip Davenport on behalf of the Construction Payment Group*
Response to Coopers & Lybrand Report of August 1996.

Document 7 *Australian Bankers' Association*
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Document 11 *Crown Solicitor's Office*
Correspondence re: Legislative proposal for security of payments - building sub-contractors.

4. Discussion Model

During this inquiry, the working party meetings canvassed a number of issues important to all parties in the contractual chain and discussed a number of other proposed measures aimed at providing security of payment to subcontractors in the building industry. Despite the support and appreciation of the need for reform, consensus on the best means for addressing the problem was not reached.

In the absence of industry consensus, the Committee proceeded with the construction of a Discussion Model. This Discussion Model is outlined in a Discussion Paper for consideration of the building industry and the public.

The Discussion Model has drawn upon a number of ideas which 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.

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

- a new Building Registration/Licensing Authority;
- compulsory registration for all contractors;
- a Building Code of Conduct;
- dispute resolution and adjudication procedures; and
- mandator security of payment insurance.

If the Discussion Model is to be adopted it will necessitate the introduction of new legislation, the amendment of existing legislation, the use of existing resources, and new dispute resolution mechanisms and procedures.

Envisaged changes are outlined in the Committee's **"Discussion Model on Security of Payment in the NSW Building Industry".**

Document 1

Construction Payment Group

Submission for introduction of statutory trusts in the construction industry

APPENDIX

CONSTRUCTION PAYMENT GROUP

SUBMISSION FOR INTRODUCTION OF STATUTORY TRUSTS IN THE CONSTRUCTION INDUSTRY

1. CPG proposes the introduction of legislation which can conveniently be achieved through amendment to the Contractors Debts Act. A draft of the legislation is **attached** to this submission. The amendments will apply only to the construction industry.

2. The proposed legislation will achieve significance against the structure as presently exists in the construction industry of what are described as cascading contractual rights and obligations. It will apply to builders, whether as construction managers, project managers or construction companies, sub-contractors and all entities in the construction chain.

3. The legislation envisages that the trustee obligations which will be imposed are imposed in respect only of receivables and monies which have been received or are owing in the construction chain but successively through the successive or dependent contracts and sub-contracts for the provision of labour, services and goods.

4. Where the contracting party upstream is a corporation, the legislation will apply to funds or receivables received or owing by either that corporation or any related corporation as defined by the Corporations Law provided they were received by way of payment for work done or materials supplied in respect of improvements by a downstream goods or services provider.

5. The trust obligations will fix only on the entity which holds the funds or entitlements upstream where those funds represent an actual or notional payment for work done or goods or services provided by or through someone lower down the contractual chain. As a necessary corollary, until payment or an entitlement to be paid has been made to the entity up the chain, no trust obligation or other obligation beyond the contractual obligations arising under the relevant contract will be imposed on the upstream entity.

6. The legislation contemplates that the payments or entitlements would relate to work done or materials provided , being in the course of a construction project and that there has been work done by an entity down stream from the entity which received the

funds which work has been costed and either approved by agreement or certification by the upstream entity. The proposal envisages that any funds which have been received will be paid within 7 to 14 days and that until all parties who have rendered their accounts down the chain have been paid the entity upstream cannot deduct its own share of the payment which has been received by it other than on a pro rata basis.

7. Where the project as a matter of practice does provide for certification of progress claims, then the issue of a certificate will be final evidence of the quantum of the entitlement of the beneficiary. The legislation also contemplates that should a person holding funds as trustee under the legislation fail to pay the beneficiary his or its entitlement, the beneficiary would not be obliged to undertake further work in respect of that project.

8. It is not part of the proposal that the legislation would otherwise superimpose on existing contractual rights and entitlements. Care should be taken to remember that the statutory trust entitlement arises only where the entity upstream actually has received money or has enforceable entitlements in respect of work done by the entity downstream. Where the funds which are held are insufficient to pay all entitled beneficiaries downstream, they would be required to be distributed pro rata between those beneficiaries including the contractor for its progressive entitlement.

9. Enforcement of entitlements against this background would be through normal Court or dispute resolution procedures. The additional remedy for breach of trust is an action for tracing of the funds. Should the funds have been diverted by the upstream entity into another account or other assets the beneficiary would be entitled to follow those funds and on identifying them obtain an order that they be repatriated to the relevant beneficiary.

10. No conflict would arise with priorities in an insolvency situation as presently exists under the Corporations Law and Bankruptcy Act. Because the funds which are received upstream are impressed with beneficial entitlements upon their receipt to those downstream, those funds on receipt would not be beneficially owned by the defaulting upstream entity and therefore would not form part of the bankrupt estate and would not fall into assets distributable in a winding up or bankruptcy. The only criminal sanctions required by the legislation will be penalties for breach of the legislation as by participating in a wilful breach of trust.

Document 2

Construction Payment Group

Proposed amendment to the Contractors Debts Bill

ATTACHMENT 1

REVISED WORDING OF PROPOSED LEGISLATIVE AMENDMENT TO CONTRACTORS DEBTS BILL

FAX RECEIVED 24 DECEMBER 1997

From Mr J Rollason
On behalf of
Construction Payments Group

Content confirmed 14 January 1998
Note changes to Clause 18 "Suspension of Work"

PROPOSED AMENDMENTS TO THE CONTRACTORS DEBTS BILL

(Add the following new Part immediately before the existing Part 3 and renumber the existing Part 3 and the clauses in it)

Part 3 Moneys received on trust

14. Money received by contractors

(1) For the purposes of this part,

contractor includes any Related Body Corporate of the contractor as defined in the Corporations Law.

improvement means any change or proposed change to land or anything erected on or under land and includes landscaping, fit out, decoration, repair and maintenance.

materials include materials, chattels, plant and equipment and includes supply by way of hire.

services includes professional services.

(2) All amounts:

(a) owing to a contractor whether or not due and payable; or

(b) received by a contractor;

for carrying out an improvement constitute a trust fund for the benefit of:

(I) subcontractors to the contractor; and

(ii) other persons

who have provided work, materials or services for or to the contractor for the purpose of carrying out the improvement.

(3) The contractor is the trustee of the trust fund and the contractor must not appropriate or convert any part of the trust fund to the contractor's own use or for any purpose inconsistent with the trust until all persons for whose benefit the trust is constituted are paid in full all amounts owed to them for the work, materials or services supplied by them.

15 **Retention moneys and security**

(1) If a contract includes provision for the retention by the contractor from progress payments of amounts as security for performance, amounts retained shall be held in a separate account (which must be called "the retention trust account") for the

benefit of the person against whom the retention is held.

(2) If a contract includes a provision for the lodgment of security for performance, if the security is in cash or is converted to cash, the cash shall be held in a trust account (which must be called "the security trust account") for the benefit of the person lodging the security.

16 **Set off**

The contractor as trustee may retain from trust funds constituted by sections 14(2), 15(1) and 15(2) an amount that, as between the contractor and any one beneficiary, is equal to the balance in the contractor's favour of any moneys owed by the beneficiary to the contractor relating to the work done or materials supplied by the beneficiary.

17 **Notification of amounts receivable or received**

Within fourteen (14) days after demand in writing to a contractor by any person to whom such contractor owes money for work done or materials supplied pursuant to a contract such contractor must supply to the person making such a demand a notice in an approved form that sets out particulars of all amounts which constitute or may have constituted the trust fund and of payments made out of such trust fund.

Maximum penalty - 20 penalty units.

18 **Suspension of work**

If within, 7 days after receipt of an amount which constitutes a trust fund under section 14, the contractor fails to pay a beneficiary the amount which the beneficiary is entitled to receive from the fund, the beneficiary may give the contractor 7 days notice of intention to stop carrying out work for or supplying materials or services to the contractor.

If before the expiration of 7 days after receipt of the notice, the contractor fails to either:

(a) pay the beneficiary the beneficiary's entitlement from the fund; or

(b) pay that amount into a separate trust account, specifically identified as for the benefit of the particular beneficiary.

the beneficiary may stop carrying out work for or supplying materials or services to the contractor until the contractor satisfies (a) or (b).

The rights provided in this section are additional to any legal rights.

(Replace the existing subclause (1) of clause 15 "Defaulting contractor to give information concerning principal" with the following clause):

(1) On demand by any person to whom a defaulting contractor owes money for work or materials, the defaulting contractor must supply to the person a notice in an approved form that sets out the name of any person from whom the person may be able to recover a debt due under this Act and particulars of amounts received by the defaulting contractor or owing to the defaulting contractor, whether or not due and payable, for work or materials that the principal engaged the defaulting contractor to carry out or supply.

Maximum penalty: 20 penalty units.

(Add an additional clause to the existing Part 3, perhaps immediately before clause 18 "No contracting out")

Document 3

Clayton Utz

Comments on draft amendments to the Conractors Debts Bill relating to statutory trusts

CLAYTON UTZ

COMMENTS ON DRAFT AMENDMENTS TO THE CONTRACTORS DEBTS BILL RELATING TO STATUTORY TRUSTS

Clayton Utz
Levels 27-35
No.1 O'Connell Street
SYDNEY NSW 2000

1. Clayton Utz were briefed by the Property Council of Australia ("**PCA**") and the Australian Constructors Association ("**ACA**") to comment upon draft amendments to the Contractors Debts Bill relating to the setting up of statutory trusts in the construction industry.

2. When briefed we were advised by the PCA and ACA of the following 4 assertions which have been made by the authors of the amendments:

   (a) no separate trust funds will need to be established;

   (b) contractors would not know the trust exists except in the event of the insolvency of the contractor;

   (c) the practice of major contractors passing money between projects would continue unimpeded and be unaffected by the proposal provided that their bills are paid, ie. for contractors who pay their bills the legislation would be invisible; and

   (d) the proposal would not interfere with normal commercial transactions.

   In our view none of these assertions is correct.

3. Issues which we were asked to consider included:

   (a) the inter-relationship between the proposed amendments and general trust law;

   (b) the effect of the proposed amendments on the day-to-day operations of the construction industry; and

   (c) the inter-relationship between the proposed amendments and existing

legislation relating to insolvency.

4. The proposed amendments are surprisingly brief for such a complex issue. In essence, it is our view that the proposed amendments are pervaded by uncertainty. In particular:

(a) there is minimal guidance as to how they will inter-relate with existing trust law and contractual relationships. From a practical point of view, participants in industry are left in the dark as to the extent they must apply and observe the law of trusts in carrying out day-to-day operations. In absence of detailed provisions can only be assumed that the law of trusts applies virtually to its fullest extent which defies commercial reality, and will lead to extraordinary commercial consequences and additional and complex administrative burdens;

(b) it is not clear who precisely is covered by the legislation. In this context, the legislation appears to apply to a whole range of industries other than the construction industry; and

(c) it is not clear precisely what property is to become trust property.

5. The proposed amendments will have significant consequences in the event of insolvencies, in that they will remove what would otherwise be a substantial portion of an insolvent entity's assets from those assets distributable to creditors. Statutory priorities, established for cogent policy reasons, will be reduced in significance, for example, statutory priority given to employees.

6. Given the uncertainties, both legal and practical, which the proposed amendments would, in our view create, we do not believe that the proponents' objectives of providing increased security of payment to subcontractors in the construction industry will be achieved.

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INTRODUCTION

1. The purpose of this paper is to provide detailed comments on the proposed amendments ("**Amendments**") to Part 3 of the Contractors Debts Bill 1997 ("**Bill**") relating to statutory trusts put forward by the Construction Payment Group in a submission to the New South Wales Parliament's Standing Committee Upon Small Business ("**CPG Submission**") and, if enacted into law, the likely consequences for the construction industry. In this context we note that, so far as we are aware, the industry has not had an adequate opportunity to consider or comment on the Amendments.

2. As with any legislative amendment, the Amendments have three distinct elements:

   (a) policy elements;

   (b) legal elements; and

   (c) practical elements.

3. It is not the object of this paper to examine the policy elements of the Amendments, except insofar as they are impact upon the legal or practical elements.

4. This paper is structured as follows:

   (a) "Summary of Conclusions" - a brief summary of our major conclusions;

   (b) "Summary of Amendments" - a brief summary of the Amendments;

   (c) "Establishment of the General Trust Scheme" - this section provides an analysis of the Amendments insofar as they seek to establish a general trust scheme and highlights other relevant matters;

   (d) "Retention Moneys and Security" - this section provides an analysis of the Amendments insofar as they seek to establish a trust scheme for retention moneys and proceeds for security and highlights other relevant matters;

(e) "Right to Suspend" - an analysis of the proposed statutory right to suspend for non-payment contained in the Amendments;

(f) "Answers to Assertions by the Authors of the Amendments" - this section provides answers to a number of assertions made by the authors of the Amendments as communicated to us by the PCA and ACA; and

(g) "Achievement of the Proposal in a Simpler Way" - a brief discussion on whether the objectives of the proposal can be achieved in a simpler way.

5. Where in this paper a word appears in italics without quotation marks (eg. *contractor*) this is because it is a defined term in the Amendments or the Bill.

SUMMARY OF CONCLUSIONS

6. The Amendments are likely to result in considerable legal and practical uncertainty within the construction industry if they were to be enacted.

7. The approach taken is too simple. Our research, and legislative experience elsewhere, suggests that considerably more detail is required to achieve such potentially far reaching consequences.

SUMMARY OF THE AMENDMENTS

8. In essence the Amendments:

(a) seek to create a general trust fund of money owing to, or money received by, a *contractor* for work performed or materials or services provided by the *contractor* (clause 14);

(b) seek to create a statutory trust of cash retentions and proceeds from security for performance (clauses 15(1) and (2));

(c) seek to create a right of set-off for the *contractor* in respect of the moneys

the *contractor* holds under clauses 14 and 15 (clause 16); and

(d) seek to create a regime for, and statutory rights in relation to:

(i) enquiry by a person who is owed money by a *contractor* for work done or material supplied pursuant to a contract into the general trust fund constituted under clause 14 (clause 17); and

(ii) suspension of work by an unpaid beneficiary unless the beneficiary's entitlement is either paid or paid into a separate trust account (clause 18).

9. The Amendments also contain a proposal for the replacement of the existing clause 15(1) of the Bill. This is discussed in paragraphs 76 to 82 below.

ESTABLISHMENT OF THE GENERAL TRUST SCHEME

General

10. At general law, a trust has 3 essential elements:

(a) the trustee;

(b) the trust property; and

(c) the beneficiary.

11. The trustee holds title (which may be legal or equitable) in the trust property and is under a personal obligation to deal with the trust property for the benefit of the beneficiary. The trust property must be identifiable and capable of being held on trust.

Provisions Setting Up the General Trust Scheme

12. Clauses 14(2) and (3) of the Amendments purport to establish the 3 necessary

elements for the general trust scheme as follows:

> *"(2) All amounts:*
>
> *(a) owing to a contractor whether or not due and payable; or*
>
> *(b) received by a contractor;*
>
> *for carrying out an improvement constitute a trust fund for the benefit of:*
>
> *(i) subcontractors to the contractor; and*
>
> *(ii) other persons*
>
> *who have provided work, materials or services for or to the contractor for the purpose of carrying out the improvement.*
>
> *(3) The contractor is the trustee of the trust fund and the contractor must not appropriate or convert any part of the trust fund to the contractor's own use or for any purpose inconsistent with the trust until all persons for whose benefit the trust is constituted are paid in full all amounts owed to them for the work, materials or services supplied by them."*

13. Clause 16 contains a "set-off" clause as follows:

> *"The contractor as trustee may retain from trust funds constituted by sections 14(2), 15(1) and 15(2) an amount that, as between the contractor and any one beneficiary, is equal to the balance in the contractor's favour of any moneys owed by the beneficiary to the contractor relating to the work done or materials supplied by the beneficiary".*

14. Clause 17 contains certain notification requirements:

"Within fourteen (14) days after demand in writing to a contractor by any person to whom such contractor owes money for work done or material supplied pursuant to a contract such contractor must supply to the person making such demand a notice in an approved form that sets out particulars of all amounts which constitute or may have constituted the trust fund and of payments made out of such trust fund.

Maximum penalty - 20 penalty units".

Trustee

15. Any *contractor* which contracts for the "*carrying out of an improvement*" will be a trustee.

16. The term *contractor* is defined to include "*any Related Body Corporate of the contractor as defined in the Corporations Law*". However, no definitive meaning of the term *contractor* is provided. Therefore there is some doubt as to what precisely a *contractor* is and therefore who precisely is to be bound by the provisions of the general trust scheme. However one can probably assume that a *contractor* is a person who contracts with another to do something.

17. The term *improvement* is broadly defined encompassing *"any change or proposed change to land or anything erected on or under land* and *includes landscaping, fitout, decoration, repair and maintenance"*. Contrary to the statement contained in paragraph 1 of the CPG Submission that the general trust fund *"will apply only to the construction industry"*, this broad definition has the clear potential to pick up *contractors* which one would not normally contemplate as being part of the construction industry. For example, the definition would cover contract gardening and cleaning work.

18. The term *"carrying out"* is not defined and its scope is not clear. It probably encompasses the work directly involved in executing the physical change on the land, for example, actual construction, repair or maintenance work on the land. It is also highly arguable that the term encompasses other activities related to the *improvement*

but which are not directly involved in executing the physical change on the land, for example, design work, project management, cost planning and geotechnical surveys. This is because an *improvement* includes a *"proposed change to land"* so, for example, it would seem to follow that "*carrying out an improvement*" must include pre-construction activities. Further, beneficiaries of the trust fund will include persons who provide *services* which include, pursuant to clause 14(1), *"professional services"* (refer to paragraph 30 below for discussion on beneficiaries).

19. There are therefore a wide range of persons who may be trustees. First, there are head contractors engaged by principals to have primary responsibility for the physical execution of the improvement.

20. Second, principals themselves could arguably be trustees. For example, a principal may enter into a facility arrangement with a financier under which the principal undertakes to carry out an *improvement* for which the financier undertakes to provide finance. Amounts provided under this facility may be included in clause 14(2) as amounts *"received by a contractor for carrying out an improvement"*.

21. Third, consultants, including, for example, design, cost and geotechnical consultants and project managers may be trustees for the reasons stated in paragraph 18 above.

22. Fourth, subcontractors of head contractors and consultants (and subcontractors of those subcontractors and so on down the contractual chain) will be trustees. Clauses 14(2) and (3) make no distinction between *contractors* which are, for example, head contractors and those which are subcontractors to head contractors. The outcome could be, for example on a major project, 200 trustees all operating trust accounts.

23. In summary:

(a) the general trust scheme will apply to a wide range of industries, not merely the construction industry; and

(b) most, if not all, participants in those industries may be trustees under the scheme.

Trust Property

24. The definition of the trust property in clause 14(2) is far from clear. In relation to clause 14(2)(a), an *"amount"* which is *"owed"* to a *contractor* cannot be held on trust by the *contractor*, because until the *contractor* actually receives the *"amount"*, it has no title to the *"amount"*. What a *contractor* has prior to receipt of actual money is a legal right to receive that money (which right ordinarily arises pursuant to a contract). This right is described as a chose in action. Presumably what is meant to be held on trust is this chose in action or alternatively, the benefit of the principal's obligation to pay the amount to the *contractor*.

25. There is as well the additional complication where the trustee is, for example, a *"subcontractor"* of a *contractor*. Is the property held on trust to be the *"subcontractor's"* contractual right to payment or is it to be beneficial interest of the *"subcontractor"* in the *contractor's* trust fund? The point is important because the nature of the property will determine the nature of the remedies available to enforce the right (refer to paragraph 52 below).

26. There is no definition of the concept of *"owed"*. How is it to be determined whether an amount is *"owed"*? Who is to determine this? Paragraph 6 of the CPG Submission refers to determination by *"agreement or certification by the upstream entity"*, but no reference is made to this in clause 14(2). The following further comments are made:

(a) many contracts to which these trust provisions apply may have no concept of certification, for example, employment contracts (see paragraph 30(c) below);

(b) what if a certification is disputed? Is the *"amount which is owed"* the amount originally certified or is it an amount subsequently determined by, for example, an arbitrator or court?; and

(c) in relation to those contracts which do embody the concept of certification there is variance as to what is to be certified. For example, clause 42.1 of

AS2124-1992 requires the *contractor* to make progress claims which:

> *"... shall include the value of work carried out by the Contractor in the performance of the Contract to that time together with all amounts then due to the Contractor arising out of or in connection with the Contract or for any alleged breach thereof."*

On the other hand, clause 37.1 of AS4000-1997 requires progress claims which:

> *"... shall include details of the value of WUC done and may include details of other moneys then due to the Contractor pursuant to provisions of the Contract."*

Therefore amounts certified under AS2124-1992 will effectively include damages for breach of contract, whereas amounts certified under AS4000-1997 will not.

27. Clause 14(2)(a) provides that *"amounts"* which are *"owed"* will be part of the trust fund *"whether or not due and payable"*. This is difficult to follow. For example, under a construction contract which provides for certification, the payment certificate usually certifies the amount then *"due"* from the principal to the *contractor* (see, for example, clause 42.1 of AS2124-1992, clause 37.2 of AS4000-1997 and clause 10.02.03 of JCC-C 1994). One would expect the trust provisions to apply to these amounts. However, if the trust provisions extend to cover amounts which are not necessarily *"due"*, that is, certified, then presumably the trust provisions may apply to any unpaid portion of the contract price, as between the *contractor* and the principal. The effect of this is that the whole of the obligation to pay the contract price may be held on trust. This is a curious result and might have far-reaching consequences.

28. The *"amounts"* to be the subject of the trust fund must be *"owed"* to the *contractor* or received by the *contractor* for *"carrying out an improvement"*. The uncertainty surrounding the concept of *"carrying out"* has been discussed in paragraph 18 above. Further issues include:

(a) whether *"amounts"* which are *"owed"* or *"received"* by the *contractor* but which do not actually represent the value of work carried out on the *improvement*, for example, delay costs payable by a principal under a construction contract, are intended to be covered; and

(b) whether amounts *"owed"* to, or *"received"* by a *contractor* outside of a contract, for example, general law damages or amounts payable on a quantum meruit basis, are intended to be covered.

29. It also needs to be noted that clauses 14(2)(a) and (b) apply to <u>all</u> *"amounts which are owed"* or *"received"* by, a *contractor* for *"carrying out an improvement"* whether or not those amounts are attributable to work, materials or services provided by beneficiaries. That is, a general trust fund will include all *"amounts"* attributable to, for example, a *contractor's* overhead and profit and other *"amounts"* such as bonuses for early completion. In this regard it should be noted that clause 14(2) limits the benefit of the trust fund to *"subcontractors"* and *"other persons"* who have provided *"work materials as services"* for or to the *contractor*. It therefore excludes the *contractor* even where the money may not relate to work provided by a subcontractor or such other person (see paragraph 30 below).

Beneficiaries

30. The beneficiaries of the trust fund are set out in clauses 14(2)(i) and (ii). The following comments are made:

(a) as with the term *contractor*, there is no definitive meaning of the term *"subcontractor"*. Presumably a "*subcontractor*" is a person who contracts with a *contractor* for the vicarious performance of the *contractor's* obligations under another contract;

(b) the number of beneficiaries under the trust fund will usually increase over the period during which the *improvement* is *"carried out"* as more *"subcontractors"* and *"other persons"* become involved;

(c) the term *"other persons"* would appear to extend to employees of the *contractor* but probably only those directly involved in doing work on the relevant improvement. This may have the effect of introducing elements of trust law into employment relationships thereby potentially complicating them; and

(d) it is not clear whether the *"work, materials or services"* must have been provided by the *"subcontractor"* or *"other person"* specifically for the purposes of carrying out the relevant *improvement*. For example, would a *"subcontractor"* who provides the *contractor* with a quantity of materials which at the time of supply have not been allocated to any particular *improvement* be a beneficiary? On the other hand, if at the time of the provision of the materials, the *contractor* has allocated the materials to a particular *improvement*, would it be necessary for the *"subcontractor"* to have knowledge of this allocation in order to provide those materials *"for the purpose of carrying out the improvement"*?

Multiple Trust Funds

31. From the drafting of clause 14(2) it would seem that separate trust funds are established for each separate *improvement* that a *contractor* carries out. So, a *contractor* cannot have one trust fund covering all *improvements* in New South Wales.

Operation of the General Trust Schemes

32. Apart from the establishment of general trust schemes under clause 14, the way in which these trust funds are intended to operate must be examined. The major issue would seem to be the identification of the rights, duties and powers of trustees and beneficiaries.

33. The first difficulty encountered in identifying these rights, duties and powers is that the purpose of the general trust schemes is not expressly set out. For example, the trustee has no express power to actually pay beneficiaries amounts *"owed"* to them from the trust fund. Likewise, the precise extent of each beneficiary's interest is not expressly set out. This is a critical omission which creates uncertainty. That is, it

is not expressly stated whether a beneficiary's interest is equal to amounts *"owed"* to it for *"work, materials or services supplied"* by it or whether the beneficiary has a proportionate share in the trust fund corresponding to the amounts which are owed to it (that is, an interest *pari passu* with other beneficiaries). These aspects require further clarification and elaboration.

34. The second difficulty involves determining how comprehensive the statutory scheme is intended to be in defining the rights, duties and powers. There are 2 questions to be answered here:

(a) to what extent is the statutory scheme intended to codify these rights, duties and powers and to what extent will the general law of trusts apply to the trust funds?; and

(b) to what extent is the statutory scheme intended to override contractual rights and obligations?

Codification

35. Given the brevity of the statutory provisions, it would seem unlikely that the statutory scheme is intended to be a code of the rights, duties and obligations of trustees and beneficiaries. Therefore the general law of trusts will apply to the extent it is not inconsistent with any of the statutory provisions (see *Registrar of the Accident Compensation Tribunal v. Federal Commissioner of Taxation* (1993) 178 CLR 145). For example, the term "*trustee*" in clause 14(3) is not exclusively defined, so one must necessarily refer to general law principles to determine its meaning. In New South Wales, general law principles are expounded upon in the *Trustee Act* 1925. It is not clear whether this legislation will apply to the general trust scheme.

Duties of Trustees - General

36. At general law a trustee stands in a fiduciary relationship with the beneficiaries of the trust. That is, the trustee must act for the benefit of the beneficiaries (both present and future) at all times. This fiduciary relationship imposes various duties upon the trustee. These have been divided into 4 broad categories (see Ford and Lee,

Principles of the Law of Trusts, par 9030):

(a) the duty of efficient management;

(b) the duty of loyalty;

(c) the duty to keep and to render to the beneficiaries full and candid accounts; and

(d) the duty to act personally.

37. Of most significance in this context are the duties referred to in paragraphs 36(b) and (c) above. These are discussed specifically in paragraphs 38 to 44 and 45 to 50 below.

Duty of Loyalty

38. Generally, the duty of loyalty requires a trustee to observe the terms of the trust and to manage the trust property efficiently in the best interests of the beneficiaries (see *Cowan v. Scargill* [1985] Ch 270).

39. As part of the requirement to observe the trust terms, a trustee must not pay out to any beneficiary any more than that to which the beneficiary is entitled to under the terms of the trust. If the extent of a beneficiary's interest in a trust established under the statutory scheme is equal to *"amounts"* which are *"owed"* to the beneficiary by the trustee, there may be significant consequences for dispute resolution. For example, a dispute might arise between a *contractor* and a *"subcontractor"*. The dispute may be settled with the *contractor* agreeing, but without admitting liability, to pay the *"subcontractor"* a certain *"amount"*. It is questionable whether this *"amount"* could be classified as an *"amount"* which is *"owed"* because there is no admission of liability. Therefore the *contractor* would risk being in breach of trust if it paid the amount out of the trust fund. To avoid any risk, it would have to be paid out of the *contractor's* own funds which may not be practicable and cause accounting complexities.

40. Even if one could classify the *"amount"* paid in settlement as one which is *"owed"* there are complications. Specifically, the duty of loyalty requires the trustee to treat beneficiaries impartially and not confer an advantage upon one beneficiary at the expense of all others (see *Tanti v. Carlson* [1948] VLR 401). The voluntary settlement of a dispute with a single *"subcontractor"* which necessarily dissipates the funds available for other beneficiaries, could well amount to a breach of the duty to act impartially.

41. As part of the duty of loyalty a trustee must not mix trust funds with its own funds or otherwise use trust funds for its own purposes. Following from this, if a trustee is a trustee for more than one trust, it must keep the accounts of each trust entirely separate (see *Skinner v. Trustees Executors and Agency Co. Ltd* (1901) 27 VLR 218). Therefore, for example, a *contractor* must not use funds received in relation to one *improvement* to pay *"subcontractors"* on another *improvement*. Likewise it must not withdraw funds for the purposes of its own overhead and profit.

42. Clause 14(3) appears intended to modify this principle and give the trustee some rights to use trust funds for its own purposes. However the following comments are made:

(a) the rights are not expressly granted;

(b) the rights may be subject to clause 16 which is discussed in paragraph 54 below; and

(c) the rights would appear not to arise until all beneficiaries have been paid "*all amounts owed to them*". It is not clear at what point or points in time this will occur or what precise criteria must be satisfied for this to occur. Will it occur progressively while the *improvement* is being "*carried out*", for example, on a monthly basis after all beneficiaries have received their monthly payments? On the other hand, will the *contractor* have to wait until the *improvement* has been complete and <u>all</u> accounts have been settled as between the *contractor* and the "*subcontractors*" and relevant "*other persons*"? If the former, what if there is a dispute as to the quantum of a monthly payment? The trustee would risk being in breach of trust if it were to withdraw its margins from the trust fund during that month. If the

latter, the *contractor* could not withdraw its margins until the completion of the *improvement*.

43. Clause 16 gives a *"contractor as trustee"* certain rights to *"retain"* amounts from the trust fund. This is discussed in detail below at paragraph 54. As is apparent from those comments complications may arise which impact upon the trustees duty of loyalty.

44. A trustee is also not entitled to any unauthorised profit earned using the trust fund and must account to the beneficiaries for such profit (see *Boardman v. Phipps* [1967] 2 AC 46). Therefore, for example, any interest earned on trust funds must be held for the benefit of the beneficiaries unless they all agree otherwise. The Amendments do not address the issue of how such profits are to be divided between beneficiaries and when they are to be distributed. This will also have tax implications, as the trustee will, to the extent interest is earned but not distributed (in a tax sense), need to file a tax return and pay tax on this interest.

Clause 17 and the Duty to Keep and Render Accounts

45. At general law, subject to certain exceptions, a trustee must keep and provide to beneficiaries full records of its actions as trustee including appropriate financial accounts (see *Burrows v. Watts* (1855) 43 ER 859). The records must disclose how the trustee has dealt with trust property and how it has complied with the terms of the trust. Accounts must be provided to beneficiaries for inspection upon request (see *Re Whitehouse* [1982] QdR 196).

46. Clause 17 appears intended to codify, at least in part, this duty. The most significant issue arising out of this duty and clause 17 is that any one beneficiary can at any time require full details of trust funds and *"amounts"* coming in and out. Therefore the beneficiary will have access to commercially sensitive information such as the trustee's margins and amounts being paid to other beneficiaries. If the trust property includes the obligation of the principal to pay the *contractor* the whole of the contract price (refer to paragraph 24 above) then beneficiaries will have details of the contract price which may be commercially unacceptable.

47. Additionally, clause 17 creates a criminal offence. The uncertainty therefore about exactly what property constitutes the trust fund is also important here. We also note the use of the phrase *"all amounts which constitute or may have constituted the trust fund"* renders the exact nature of the records to be kept unclear.

48. Also:

(a) the clause does not specify the date to which the particulars of amounts provided must be current. Is it the date of demand or some later date?

(b) our comments in relation to clause 16 and the use of *"owes"* apply equally here.

49. The administrative burdens placed upon *contractors* by this duty appear formidable. Every decision made which may in any way affect the rights of beneficiaries will have to be fully documented. From an accounting point of view there are likely to be complications, for example, salaries and wages of employees who spend some of their time working on an *improvement*, will need to be appropriately apportioned to the trust fund and treated independently from the *contractor's* payroll system.

50. A trustee's duty of disclosure embodied in the duty to keep and render accounts also extends to a duty to inform beneficiaries of their rights under the trust, whether or not such information is requested (see *Hawkesley v. May* [1956] 1 QB 304). So, for example, a *contractor* has a positive duty to inform all *"subcontractors"* of their rights, which may be a cumbersome administrative task, particularly if, for example, materials when supplied were not specifically allocated for the purpose of the *improvement*.

Relationship with Contractual Provisions

51. There is a clear uncertainty as to the effect that the Amendments will have upon contractual provisions between trustees and beneficiaries. A clear example of this lies in the area of dispute resolution. If a *contractor* refuses to make a payment claimed to a *"subcontractor"* does the *"subcontractor"* dispute the refusal under the dispute resolution procedures of the contract or must it commence court proceedings in

equity? The difficulty is that there are essentially 2 regimes governing the payment of money: the contractual regime and the trust regime. Can the outcome of dispute resolution procedures under one regime affect the outcome under the other regime? We note in this respect particularly that many dispute resolution clauses would not catch or cover disputes concerning the trust fund. For example there is much scope for argument concerning the common formulation "arising out of or in connection with the Contract". Does this include statutory trust fund disputes? If not, what does this do to the principle of party autonomy in dispute resolution?

52. Related to this point is whether beneficiaries may pursue contractual remedies for non-payment or equitable remedies or both. A contractual right (assuming it is available) is a legal right and is not within the discretion of the court once the facts are found. An equitable remedy is however discretionary.

Other Uncertainties

53. It is usual for a trustee's general law duties to be refined, or at least expounded upon, by the terms of the trust. From a practical point of view, particularly in a commercial context, the trustee will require some guidance as to what it may and may not do in administering the trust. The general trust scheme established under clause 14 provides virtually no such guidance to trustees (refer to paragraph 35 above). Many issues which may arise during the course of an *improvement* are not addressed. For example:

(a) because trust property includes the benefit of obligations, does this mean, for example, that a *contractor* cannot agree to a novation of the principal's obligations under its contract, including where the principal's financier requires "step-in" rights upon default by the principal?;

(b) is a *contractor* entitled to settle claims with its principal for *"amounts"* which it is *"owed"* or must it pursue claims until a final determination (for example, by a court) is made? If a *contractor* agrees to settle a claim for less than its full legal entitlements then it has arguably dissipated the trust assets which would be a breach of trust. Indeed it is arguable that the *contractor* cannot make any decision which could affect its rights as against

the principal without fully considering the interests of beneficiaries (including future beneficiaries) and acting in their best interests. This defies commercial reality and will only increase reliance upon litigation as a method for dispute resolution; and

(c) there is no provision for the retirement of trustees. At general law a trustee cannot retire unless the trust instrument permits this, there is consent from all beneficiaries or the trustee's duties are completely discharged (see *Re Heberley* [1971] NSWLR 325). The *Trustee Act* 1925 provides for retirement by order of the court, but as stated above, the applicability of this legislation is not clear. This has significant consequences for, say, a turnkey contract where the *contractor* finances construction. Usually the *contractor's* financier will require "step-in" rights in the event of default by the *contractor*. However the *contractor's* trust obligations and its inability to retire would seem to prevent it from agreeing to this.

Set-Off

54. Inextricably linked to the general trust scheme is the right of set-off appearing in clause 16 of the Amendments. The following comments are made:

(a) it is not clear whether clause 16 is intended to be an exhaustive statement of a trustee's rights to retain funds as contemplated in clause 14(3) (refer to paragraph 35 above). If so, then the trustee will be unable to withdraw its margins from the trust fund. This is clearly unsatisfactory and will have clear cost implications;

(b) *"amounts"* entitled to be withdrawn are *"amounts"* which are *"equal to the balance in the contractor's favour of any moneys owed by the beneficiary to the contractor"*. This is not clear. When is this *"balance"* determined? Who determines it? What if it is disputed? In this context refer to paragraph 26 above concerning certification;

(c) *"amounts"* must relate to *"the work done or materials supplied by the beneficiary"*. This is very restrictive. For example, it would not cover

such things as damages (liquidated or general) *"owed"* for delay. Further it does not extend to *"amounts"* which are *"owed"* in relation to *services* provided by a beneficiary;

(d) there is uncertainty surrounding how this right relates to the trustee's duty to treat beneficiaries impartially. Clause 16 does not expressly limit the trustee's right of set-off against a particular beneficiary to the extent of that beneficiary's interest in the trust fund. Is the right intended to be so limited? If not, then, in the absence of express words to the contrary, the trustee's duty of impartiality would seem to limit the right anyway. If the trustee sets-off an *"amount"* which is greater than the beneficiary's interest then that beneficiary would essentially be gaining at the expense of the other beneficiaries contrary to the duty of impartiality;

(e) a broader issue to that referred to in sub-paragraph (d) above, is whether the trustee's fiduciary duties generally limit the statutory right to set-off. For example, must the trustee consider the interests of other beneficiaries before setting-off? Any set-off will dissipate funds available for beneficiaries at a later stage;

(f) the right of set-off is restricted to amounts *"owed"*. This clearly would provide a basis for the beneficiary obtaining an interim injunction restraining either a set-off or the use of any funds withdrawn until a determination is made by a court as to whether the *"amount"* is *"owed"*. In any event a trustee who sets-off an *"amount"* without conclusive determination that the *"amount"* is *"owed"* is clearly risking a breach of trust; and

(g) what does retain mean? Does it mean that the contractor can withdraw the money (and is not thereby appropriating or converting the fund under clause 14(3)) or does it simply mean that the contractor can have what is left after *"all persons for whose benefit the trust is constituted are paid in full"*?

Constructive trustees

55. *Barnes v. Addy* is a 19th century case which establishes that strangers to the trust who knowingly deal with trust property in a manner inconsistent with the performance of the trust will be subject to constructive trusteeship. The circumstances which attract constructive trusteeship include:

(a) where a stranger receives or deals with trust property. Persons who receive or deal with trust property knowing that such receipt or dealing is in breach of trust will be held to be constructive trustees of the property. The knowledge required for constructive trust liability to accrue is:

(i) actual knowledge;

(ii) wilful shutting of the eyes to the obvious;

(iii) wilful and reckless failure to make inquiries that an honest and reasonable person would make; or

(iv) knowledge of circumstances that would indicate the facts to an honest and reasonable person; and

(b) where a stranger assists a trustee (or other fiduciary) in a dishonest and fraudulent design. Persons who knowingly assist a trustee or other fiduciary in a dishonest and fraudulent design, or induce such a breach of duty, will be personally liable for any resultant loss, and held accountable in respect of such gains, to the relevant fund. To make a stranger liable for knowing assistance the plaintiff has to show:

(i) that a fiduciary relationship existed;

(ii) a dishonest or fraudulent breach of duty on the part of the fiduciary;

(iii) the stranger's assistance in the dishonest design, which assistance

need not cause the loss and could be an intermediate step in the process leading to the breach of duty; and

(iv) requisite knowledge on the part of the stranger.

56. Parties which could be caught by these principles include directors of *contractors* where there are breaches of trust and financiers of *contractors* who receive repayments for finance from trust funds in breach of trust.

Effect on Financial Statements

57. In order for a *contractor's* financial statements to give a "true and fair view" of the *contractor's* financial position, they will need to reflect the fact that in relation to some of its assets, the *contractor* owes fiduciary duties. This may require a more conservative approach to be taken in relation to the recognition and valuation of assets.

Effect on Ability to Obtain Finance

58. There may be a degree of reluctance on the part of financial institutions to grant or extend credit to *contractors* where their sole source of income is subject to a statutory trust in relation to which they have no beneficial interest. Consequently, *contractors* may be unable to finance their operations from their own funds because they are subject to a statutory trust, and also unable to borrow. Risk is also created for financiers by the principles of *Barnes v. Addy* (refer to paragraph 55 above) and potential limitations on "step-in" rights in the event of default of both "principals" and *contractors*.

Contractor Insolvency

59. The primary effect of the Amendments is to take *"amounts"* received in relation to *improvements* out of the reckoning on an insolvency because they are held on trust (*Barclays Bank Ltd. v. Quistclose Investments* [1970] AC 567 and *Re Kayford Ltd. (in liqu)* [1975] 1 All ER 604). The entitlement of a beneficiary would be satisfied by an entitlement to a share in the trust fund. This would very significantly change the

nature of a distribution in the event of *contractor* insolvency and have the practical effect of securing the claims of the beneficiaries (as the trust fund would not be available for distribution on an insolvency, but would be distributed to the beneficiaries). In this context it needs to be noted that the evolution of priorities in insolvency and bankruptcy law has been a gradual process involving much debate and detailed consideration. Enactment of the Amendments would cut across all of this. For example, under the Corporations Law, employees' claims for service before the beginning of a winding up (including claims for wages, superannuation contributions, injury compensation, leave and retrenchment payments) are to be paid in priority to claims of other creditors. The general trust scheme cuts across this statutory priority in 2 senses:

(a) the assets over which employees have priority will be significantly reduced as trust assets are excluded; and

(b) those employees who are beneficiaries under the trust schemes will have to share those assets with other beneficiaries, who the employees would normally have priority over, on a pari passu basis.

60. Whilst we have not conducted detailed research in this respect, we believe that there is a possibility of successful arguments being run to the effect that the Amendments are inconsistent with some Commonwealth legislation and may therefore be void to the extent of the inconsistency.

Other Statutory Trust Schemes

61. It is correct to say that there are a number of other statutory trust schemes in operation, for example, the solicitors' trust scheme under the *Legal Profession Act* 1987. However there are significant differences between these and the general scheme embodied in the Amendments, such as:

(a) a solicitor's trust fund is made up of specific amounts provided for specific purposes by clients. Therefore there is no doubt as to who the beneficiaries are and the extent of the beneficiaries' interests. For example, interests will not be subject to disputation as to whether amounts are *owed* or not;

(b) the solicitors' trust scheme does not cut across solicitor/client contractual relationships;

(c) unlike contractor/subcontractor relationships, the solicitor/beneficiary relationship is not invariably one of conflicting commercial interests; and

(d) moneys which *contractors* will be required to hold on trust are moneys, which, but for the legislation, would normally be owned, not owed, by the *contractor* pursuant to its contractual relationships. Moneys held by solicitors are usually the property of clients or other third parties.

Other Australian Reports or Inquiries Which Have Considered General Trust Schemes

62. This issue of general trust schemes has been considered in New South Wales before. At paragraph 7.1 of the *NSW Government Green Paper: Security of Payment in the Construction Industry* (1996) the following passage appears:

> *"This [deemed trust] proposal has been the subject of two independent reviews:*
>
> - *The Andersen Consulting Review commissioned by the NSW Department of Industrial Relations, Employment, Training and Further Education (1993).*
>
> - *Price Waterhouse Report commissioned by the National Public Works Council (1996).*
>
> *Each of the above reviews cast major doubts on the viability of the proposed scheme. The scheme has potential hidden costs and generally the legal status of trusts in themselves were not seen as a problem. However, the reports concluded that the complexities associated with the mixing of trust moneys with other funds of a contractor, together with the impact of other existing regulations/laws on the status of such moneys, would inevitably result in a costly and complex dispute process. Therefore, recovery of trust*

funds in the event of insolvency is extremely unlikely, while existing legal remedies are available for recovery if insolvency is not at issue.

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

Any such additional punitive regime is not considered appropriate at this stage, particularly in view of the Government's recent revision of the Oaths Act (see section 4.2) and the Contractors' Debts Act (see section 4.3), the amendments by the former Federal Government of the Corporations law which imposes much greater liabilities onto company directors in relation to their corporate behaviour, and the many other existing legal forums available for relief."

63. We note also that the use of trust funds as a means of addressing security of payment concerns in the construction industry has previously been considered on numerous occasions (eg. by the Western Australian Law Reform Commission (1974) and the Queensland Government (1991) and (1996), where both governments rejected the proposals).

Canadian Legislation

64. A number of Canadian jurisdictions have enacted trust legislation. It is important to note that the Amendments appear to be based on one or more of those Acts, although the regime does not correspond to that existing under any one Act. The jurisdictions and corresponding Acts are:

(a) Alberta - Builders' Lien Act, RSA 1980 c. B-12;

(b) British Columbia - Builders' Lien Act, RSBC 1979, c 40;

(c) Manitoba - Builders' Lien Act, RSM 1989, c B91;

(d) New Brunswick - Mechanics' Lien Act, RSNB 1973, c M-6;

(e) Ontario - Construction Lien Act, RSO 1990, c C.30; and

(f) Saskatchewan - Builders' Lien Act, SS 1984-85-86, c.B-7.1.

65. Note that while the titles of these Acts refer to liens (a charge to secure payment) the Acts themselves also make provision for statutory trusts.

66. The authors of the Canadian loose leaf publication *Construction Builders' and Mechanics Liens* (6th Edition, Macklem & Bristow - published by Carswell) say, (at page 9-1);

> *"The mechanism of the trust insulates the contract funds being paid for the work and materials that create the improvement from the claims of other creditors of the persons making such payments, such as might arise as a result of assignments, bankruptcy, and statutory liens. The legislation also seeks to provide business efficacy to the remedy by allowing proper exemptions and exceptions to payments into and out of the fund and its appropriation, while not necessarily impairing the ordinary flow of funds on any particular project."*

67. The comments made concerning the need for any legislative provision to take proper account of the need for business efficacy are particularly pertinent here. What, if any, analysis has been made of the practical consequences of the Amendments? We note the comments in the Green paper quoted above that *"the scheme has potential hidden costs"*. Again we note the many and detailed provisions enacted in some of the Canadian legislation.

68. The various Canadian Acts have been in use cumulatively for a period of many years. However we have not sought or reviewed comments from the Canadian construction industry. No doubt feedback from interested participants in jurisdictions where the same, or substantially similar legislative provision has been made would be extremely useful, in particular in assessing how the Amendments might actually work in practice (for example, cash flow and accounting implications).

69. We make the comment however that this is not a simple body of law. A considerable proportion of the two volume Canadian loose leaf service referred to in paragraph 66 above is dedicated to an analysis of the legislation and the case law it has thrown up. The chapter on the operation of the trust funds runs to 63 pages and contains detailed comments on the many practical and theoretical questions which have arisen from the various pieces of legislation. There are a great many cases which consider the operation of this legislation and it has quite clearly proved a fertile ground for litigation. The issues which the Amendments seek to address are not simple issues which can be conveniently dealt with without detailed and considered analysis. They are complex in a practical as well as a legal sense.

RETENTION MONEYS AND SECURITY

70. Clause 15 of the Amendments provides as follows:

> *"(1) If a contract includes provision for the retention by the contractor from progress payments of amounts as security for performance, amounts retained shall be held in a separate trust account (which must be called "the retention trust account") for the benefit of the person against whom the retention is held.*
>
> *(2) If a contract includes a provision for the lodgement of security for performance, if the security is in cash or is converted to cash, the cash shall be held in a trust account (which must be called "the security trust account") for the benefit of the person lodging the security".*

71. The concept of holding security upon trust is not a new one, at least in a construction context (see, for example, clause 10.23.03 of JCC-C 1994). The following comments are made:

(a) generally the issues above in relation to the general trust fund established under clause 14 will apply to trust funds established under clause 15;

(b) the provisions would appear to outlaw the not uncommon practice of

contractors using security provided by *"subcontractors"* for the purposes of providing security to the principal thereby reducing overall financing costs; and

(c) *contractors* will be required to set up a *"separate trust account"* for each *"subcontractor"* working on an *improvement*.

72. We note in particular that the statutory set-off in clause 16 gives the *contractor* rights against these trust funds. It is not clear:

(a) what the relationship of these rights is to any contractual provisions concerning the taking of retentions or security. This of course has major implications for most standard form contracts in use today. Use of the retention or security trust funds contra the statute would be in breach of trust (again we note that there is to be no contracting out of the Bill);

(b) how, if clause 16 is to codify the rights of a *contractor* against the retention or security fund, the right is to operate, given that the clause 16 right does not extend to damages but only to *"moneys owed by the beneficiary to the contractor relating to the work done or materials supplied by the beneficiary"*. As retentions and security are provided as security for performance this would appear to be a major flaw;

(c) how and when the *contractor* may access any money it *"retains"*; and

(d) what is meant by the phrase *"the contractor as trustee"*.

73. These are major concerns with the possibility of completely changing the nature of the security arrangements throughout the industry.

SUSPENSION OF WORK

74. Clause 18 provides as follows:

"If within, 7 days after receipt of an amount which constitutes a trust fund

under section 14, the contractor fails to pay a beneficiary the amount which the beneficiary is entitled to receive from the fund, the beneficiary may give the contractor 7 days notice of intention to stop carrying out work for or supplying materials or services to the contractor.

If before the expiration of 7 days after receipt of the notice, the contractor fails to either:

(a) pay the beneficiary the beneficiary's entitlement from the fund; or

(b) pay that amount into a separate trust account, specifically identified as for the benefit of the particular beneficiary.

The beneficiary may stop carrying out work for or supplying materials or services to the contract <u>until</u> the contractor satisfies (a) or (b).

The rights provided in this section are additional to any legal rights."

75. The following comments are made in relation to clause 18:

(a) due to the uncertainties as to what precisely a beneficiary is entitled to under a trust fund, and precisely what the trustee's rights and powers are, clause 18 is uncertain in its operation as well;

(b) it is not clear what precisely is to happen to any amounts, once they are placed into the separate trust account. For example, what are the *contractor's* set-off rights and when will the trust come to an end? Generally the issues above in relation to the general trust fund established under clause 14 will apply to trust funds established under clause 18;

(c) there does not necessarily have to be a correlation between the entitlement and the work suspended. So a beneficiary could suspend work on a project it is working on for the *contractor* even though the entitlement may relate to a different project. Likewise the extent of the suspension does not have to correlate with the *amount* which is *owed*. So, a multi-million dollar

project could be held up by a minor debt; and

(d) the right to suspend arises even if there is a bona fide dispute concerning the entitlement.

REPLACEMENT OF PROPOSED CLAUSE 15(1) WITH AMENDED CLAUSE 15(1)

76. The Amendments contain a proposal for the replacement of the existing clause 15(1). This amendment significantly expands the rights available under the old clause 15(1) by requiring the *defaulting contractor* (a defined term under the Bill as it stands) to supply not only the name and address of the person from whom the sums are owing but also:

(a) makes the right available on demand and without the need for the unpaid person to obtain a debt certificate;

(b) extends the right to include "*particulars of amounts received by the defaulting contractor, whether or not due and payable, for work or material that the principal engaged the defaulting contractor to carry out or supply*".

77. The requirement for a debt certificate currently operates as a restraint on the vexatious use of the clause 15(1) power as the subcontractor, to have obtained a debt certificate, will have already sued the *defaulting contractor* and a court will have determined the amount due to the enquiring subcontractor.

78. As with a number of the other Amendments there is again no way of determining what, if anything, is *"owed"*.

79. Furthermore, the clause, as currently drafted, does not adequately define what particulars the *defaulting contractor* is to supply. Thus the *defaulting contractor* must provide *"particulars of amounts received by the defaulting contractor, whether or not due and payable, for work or materials that the principal engaged the defaulting contractor to carry out or supply"*.

80. The underlined passage makes no attempt to link the *"amounts"* of which particulars

must be provided to *"amounts"* which relate in some way to the *"person to whom the defaulting contractor owes money"*. The *"amounts received"* of which particulars are to be provided, are *"amounts received"* for work or materials *"that the principal engaged the defaulting contractor to carry out or supply"*. The Bill as it stands only allows for assignment of "money that is payable to the defaulting contractor for or in respect of work carried out or materials supplied by the unpaid person"[1]. The Bill therefore clearly attempts to link the right to money payable because of something the subcontractor had done.

81. The need to get this clause drafted correctly is of particular importance, as the clause creates a criminal offence.

82. The combination of the right in the proposed amendment to clause 15, coupled with that in the proposed clause 17, means that as soon as a subcontractor believes it is owed money, it can obtain details of:

(a) all sums the contractor has received; and

(b) details of all payments to and from the trust fund.

ASSERTIONS BY THE AUTHORS OF THE AMENDMENTS

83. We have been advised by the PCA and ACA of the following 4 assertions which have been made by the authors of the Amendments:

(a) no separate trust funds will need to be established ("**Assertion 1**");

(b) contractors would not know the trust exists except in the event of the insolvency of the contractor ("**Assertion 2**");

(c) the practice of major contractors passing money between projects would continue unimpeded and be unaffected by the proposal provided that their bills are paid, ie. for contractors who pay their bills the legislation would

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1 From the explanatory note to the Bill.

be invisible ("**Assertion 3**"); and

(d) the proposal would not interfere with normal commercial transactions ("**Assertion 4**").

84. Assertion 1 is not correct. Contractors will be required to:

(a) set up separate general trust funds for each *improvement* that they undertake;

(b) separate trust funds will be required for each subcontractor with respect to which the contractor withholds retention moneys or holds cash as security; and

(c) clause 18 contemplates another layer of separate trust funds.

85. Assertion 2 is not correct, as the preceding analysis clearly shows. The industry will be pervaded by legal uncertainty and subject to burdensome administrative requirements.

86. Assertion 3 is not correct. A contractor who passes money between projects will be breaching its duties as a trustee.

87. Assertion 4 is not correct. Refer to comment in relation to Assertion 2.

ACHIEVEMENT OF OBJECTIVE OF THE PROPOSAL IN A SIMPLER WAY

88. The PCA and ACA have sought our analysis and comment on how, through the use of trusts, the objective of the Amendments might be achieved in a simpler way. In our view there is a more fundamental question, namely how the objective be achieved at all. It would seem to us that it can only be achieved through exceptionally detailed legislation which removes (at least) the multitude of uncertainties and inconsistency identified by us in this paper. The Amendments are purporting to impose a completely new legal regime upon the current contractual regime in the industry. In the absence of detailed statutory provisions, there can only be legal uncertainty as to

how the statutory regime interrelates with the current contractual regime and how these 2 regimes interrelate with the general law of trusts. Put simply, the objectives of the Amendments cannot be achieved in a simpler way but would require detailed and reasoned analysis.

Document 4

Coopers & Lybrand Consultants

Independent assessment of the viability of the NSW Security of Payment Committee Proposal, August 1996

&Lybrand
Consultants

Independent assessment of the viability of the NSW Security of Payment Committee Proposal

August, 1996

Solutions
for Business

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Executive summary

Introduction

This report by Coopers & Lybrand and Deacons Graham & James for the NSW Department of Public Works and Services (DPWS) is an independent assessment of the viability of the Security of Payment Committee (SOPC) proposal.

The stated aim of the SOPC is to provide a framework to give greater assurance to all parties in the payment chain that they will be paid for goods and services provided.

A feasibility study on the SOPC proposal was prepared by Andersen Consulting in May 1993 which recommended the proposal be rejected. The SOPC then responded to the Andersen Consulting comments. Legal comments (commissioned by the Department of Public Works) were made on the proposal by Philip Davenport and RV Gyles QC (comissioned by SOPC).

The recommendations of the Andersen Consulting report were adopted by the NSW Government and are being progressively implemented.

Methodology

In preparing this report, interviews were held with members of each of the industry sectors from bankers through to suppliers. The report contains summaries and comment on the SOPC proposal, Andersen Consulting's report, SOPC's response and subsequent legal opinion.

Comment on the SOPC proposals viability

The SOPC proposal directly addresses the symptoms and not the cause of the security of payment problem, and the proposal will not ensure that all subcontractors and suppliers will get paid. At best it will provide as a consequence of penalties a strong incentive for people to meet their obligations.

Existing legislation such as the Bankruptcy Act, Corporations Law and the Oaths Act could be reviewed to achieve a similar effect.

The SOPC proposal is not viable due to:

- the proposal is at odds with the commercial reality of the industry
- significant legal difficulties in achieving protection of monies (refer legal difficulties below)
- the existing legal system can already provide a range of remedies and sanctions for unethical behaviour
- industry specific legislation creating difficulties in the recovery process, adding to costs of recovery and time
- the complexity and cost the deemed trust will bring to the industry

Legal difficulties

The legal difficulties are in three main areas:

1. the requirement for federal legislation in relation to:

   - Bankruptcy Act: changing the statutory order of priority of creditors so that interests of contractors, subcontractors and suppliers takes priority over other creditors

   - Corporations Law: that directors acting in "Good Faith" may in many circumstances invalidate any sanctions for violation of the scheme

   - Trustee Acts: that existing trustees acting "honestly and reasonably" may in many circumstances invalidate sanctions for violation of the scheme

2. trusts may be difficult to implement due to the complex relationships being created with no guarantee that such complexity will ensure security of payment to all members in the construction chain

3. commercial uncertainty is created by imposing trust law over contract law, which will lead to significant potenital for increased levels of disputation.

Existing legal sanctions

Relevant existing sanctions include:

- Trade Practices Act: those sections relating to misleading and deceptive and unconscionable conduct
- Corporations Law: sections dealings with insolvent trading
- the Oaths Act
- common law deceit and fraud

Existing remedies

Existing remedies in place include:

- for government contruction agencies to liaise with relevant state and federal departments in order to "police" existing legal sanctions

Recommendations

The SOPC proposal in its form and in isolation would not be an effective solution to achieving the SOPC's stated aims

The SOPC proposal in isolation is not an effective solution to achieving the committee's stated aims. We recommend government

- continues implementation of the Andersen Consulting recommendations already in place such as Alternative Dispute Resolution (ADR).
- considers more effective enforcement of existing laws
- determines initiatives to encourage and require a strengthening of the financial base of industry participants
- conducts a review of successful projects to determine common links
- determines the appropriate drivers to improve the culture, ethics, professionalism and international competitiveness of the industry. An example might be a rating system based on performance for awarding contracts and the establishment of differentials for cost of funds and credit ratings
- continues to monitor factors affecting the cyclical nature of "boom and bust" in the construction industry, with the aim of moderating and influencing the industry
- improves contract accounting and status reporting between all participants in a project

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Introduction

Introduction

The policy division of Department of Public Works and Services (DPWS) requested an independent assessment on the viability of the security of payment proposal

Background

As a consequence of the NSW Royal Commission into the building industry in 1991, and following lobbying from companies associated with the construction industry, the industry was asked to submit a proposal as to how payments within all levels of its supply chain could be made more secure and timely. The NSW Security of Payments Committee (SOPC) was then formed in November 1991 to develop the proposal.

The SOPC proposal with its core recommendations being the use of legislated deemed trusts to secure payments was tabled. Andersen Consulting conducted a feasibility study into the proposal in May 1993 which recommended against its adoption but did recommended other less intensive measures. These other aspects of the report were adopted by NSW Government and are in the process of being implemented.

The SOPC in May 1994 responded to the Andersen Consulting report, rejecting its conclusions and urging that the original proposal be adopted. Legal comments were made on the proposal and the deeming provisions by P Davenport (solicitor) and RV Gyles QC respectively, commissioned by the Department of Public Works and SOPC. No formal response was given to the SOPC response to the Andersen report, but discussions were held between the Construction Policy Steering Committee and the SOPC.

Given the time elapse since the SOPC response and progress in other States, there is now growing pressure on the NSW Government to adopt a positive course of action regarding security of payments.

It is within this environment that the NSW Department of Public Works and Services (DPWS) engaged Coopers & Lybrand to perform an independent assessment of the viability of the SOPC proposal.

The output of this report is in three sections

Summary

An outline summary of:

- the SOPC proposal
- the Andersen Consulting feasibility study report
- the response by SOPC to the Andersen Consulting report (the Response)
- legal comments on the proposal by P Davenport
- advice on the deeming provisions by RV Gyles, QC

Comment

Comment on the overall viability of the SOPC proposals.

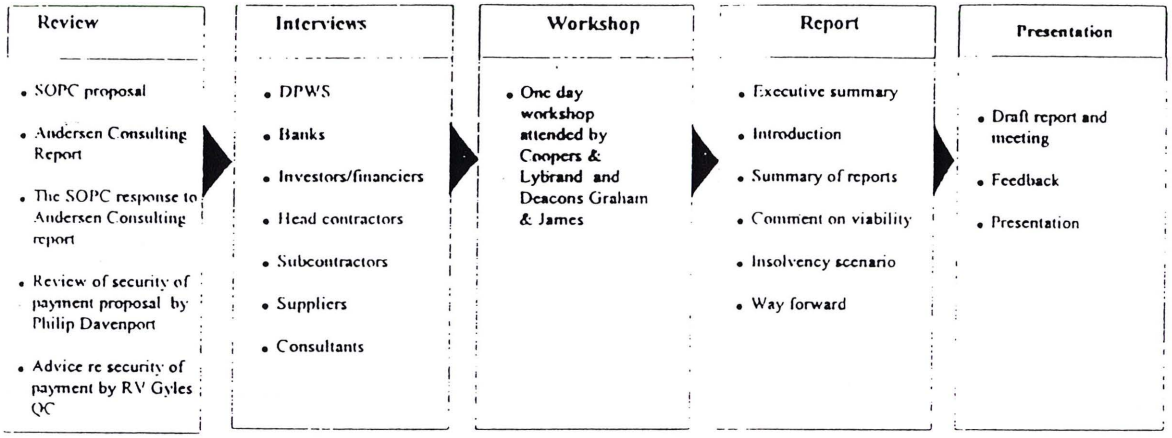
These comments represent an evaluation of the major issues of the proposal by Coopers & Lybrand, together with legal comments by Deacons Graham & James, solicitors.

Way forward

A workplan and recommendations which outlines future steps to be followed.

Approach

Coopers & Lybrand's approach to the assessment of the viability of the SOPC proposal is summarised as follows:



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Summary of reports

Summary of SOPC report

The SOPC sought a solution that could protect the flow from diversion and misuse through the supply chain from finance source to supplier

The SOPC proposal, dated 1991, involves the creation by legislation a comprehensive deemed trust scheme.

The intent of the trust is to provide a statutory obligation on the trustee which will give rise to obligations for personal liability for breaches without setting up separate trust accounts.

The SOPC proposal was framed to be compatible with existing laws and did not require the introduction of new laws (although this is not the case, as explained further in this report).

The proposal also sought to shorten the payment cycle to a maximum of four (4) weeks.

The SOPC proposal looked at the topic from the perspective of all parties in the supply chain

In summary, the proposal presents:

- a 'deemed' trust scheme where the monies from a certified and paid claim are held for those to whom it is rightly due
- a right of all parties to information to evidence that future payments are adequately provided for
- a certification system and a shorter payment period
- procedures for enhanced alternative dispute resolution

Andersen Consulting feasibility report

The report recommends that the government should not implement the SOPC proposal

This feasibility report into the SOPC proposal was prepared by Andersen Consulting for the Department of Industrial Relations, Employment, Training & Future Education (DIRET&FE) in May 1993.

The recommendation to reject the SOPC proposal was based on these key factors:

1. The proposal deals with issues that are considered serious in the industry as:

   - payment defaults do not appear to the extent indicated by anecdotal evidence and insolvencies are at levels which compared to other industries are not abnormal
   - there is no evidence of domino effect in payment following default
   - reasons for financial failures are not unique to the building industry and are usually due to poor financial management

2. The potential increase in project funding costs which could significantly dampen activity in the building industry

3. There are serious legal flaws in the proposal eg. problems with third parties, identification of trust assets, disputation procedures and federal constitution.

Whilst rejecting the SOPC proposal, Andersen Consulting suggested that the security of payment issue may best be addressed by tightening up on other actions

Andersen Consulting did, however propose a number of alternatives, including:

- the Government Code of Practice obligations relating to contractual payments could be strengthened by:
  - use of companion contracts and
  - mandatory trusts for cash securities and retention monies

- liaison between NSW Government and Australian Securities Commission to improve database information on insolvent and fraudulent operators

- support for Alternative Dispute Resolution (ADR) methods for the building industry

- the encouragement of industry associations to increase training of their members

- a review of the Contractors Debtors Act for relevance and applicability

SOPC Response

Introduction

The SOPC response to the Andersen Consulting study was presented in May 1994.

In his introduction the Chairman of SOPC stated that the Andersen report was " flawed and failed in its findings, conclusion and recommendations ".

The SOPC response in essence concludes that the Andersen investigation and report on the original SOPC proposal is not a complete nor worthwhile assessment of the strength and weaknesses of the SOPC proposal. Their view is that the Andersen report was prepared to promote the adoption of alternative proposals by the New South Wales Government.

The SOPC critically comments on the key findings of the Andersen investigation by questioning the data/information which was used by Andersen, challenging the methodology and approach taken by Andersen in forming their views and recommendations, and on a number of points question whether Andersen's properly understood the features of the SOPC proposal which they criticised.

The response is very detailed. It is of little benefit to restate each of the criticisms and comments raised by SOPC in relation to the Andersen report. The SOPC strongly disagree with the Andersen comments and conclusion in relation to:

- the importance of security of payments issue
- the degree of legal difficulty to overcome
- the legal shortcomings of the proposal
- the cost of the industry of the adoption of the proposal, and
- the adverse effects of shortened payment cycles.

The response did support some of the recommendations of the Andersen report such as the increased use of alternative dispute resolutions for the industry, improving the financial training of industry members, review of the Contractors Debtors Act. They also concurred with the

Andersen views that liens/charges licensing and insurance are not appropriate alternatives to achieve a solution to the problem.

Whilst the SOPC response is important in terms of questioning the soundness and credibility of the Andersen report, it by and large restates the original proposal. The additional information or matters raised in the Andersen report have not caused the Committee to reconsider the fundamentals of its original proposal. The Committee maintain that:

- the proposal is for the benefit of all parties in the industry
- that security of payment is an important issue to the industry
- that the proposal will not result in substantial additional costs to the industry
- that the domino effect does exist within the industry, and
- that there are not significant legal impediments or hurdles to be overcome to implement the proposal.

The SOPC provided a line-by-line response rejecting much of the reasoning and many of the conclusions of the Andersen Consulting report

The response state that the investigation was flawed and failed in its findings, conclusion and recommendations because emphasis was centred only on subcontractors and not equity for *all* of the participant industry groups.

The committee indicated that various papers exist which highlight that the issue of payment problems *are* large, involving millions of dollars of excessive costs from pricing the payment risk.

Andersen Consulting indicated in their report that the SOPC proposal may lead to an increase in the cost of building projects.The SOPC responded stating that this contradicted the NSW Royal Commission into the building industry which indicated a saving of 2.84% by the elimination of late payments.

The SOPC response strongly rejected many of Andersen Consulting findings and urged the Minister to hold further discussions on their original proposal.

Legal reviews

The SOPC proposal has been reviewed by two legal sources (other than Andersen Consulting, legal assistance from Gilbert & Tobin) since 1991

Review by Philip Davenport, Solicitor

Davenport felt that there were serious deficiencies in relation to aspects of the proposal. These deficiencies include:

- that the security of payment to all sections of the construction industry will be at the expense of owners and their employees. The proposal would make the owner directly responsible to unpaid subcontractors and suppliers and that this will alter the level of commercial risk on the owner. As a result this may mean an "Americanisation" of the industry ie a move to an insurance bonding system.

- that Commonwealth involvement is required in order to amend the Corporations law and the Bankruptcy Act in order to achieve the SOPC's objectives. Because Commonwealth law dictates the statutory order of priority upon insolvency of a corporation, the SOPC proposal requires changing the statutory order of priority of creditors so that the interests of contractors, subcontractors and suppliers take priority over workers and other creditors.

- that the SOPC proposal may also interfere with other priorities eg the rights of lenders and secured creditors

- the proposal subverts the rule that strangers to a contract cannot sue, eg a supplier at the bottom of the construction chain can directly sue the owner even though that supplier does not have a contract with the owner.

- that the absence of a separate trust account for trust monies on each project creates practical difficulties eg in the event of insolvency of the trustee, creditors will have difficulties in identifying their trust money.

In conclusion Davenport states that the "proposals contain unworkable aspects and are biased in favour of protecting

contractors not only in respect of security of payment but in respect of claims generally."

Davenport recommends a modified proposal, limited to contractor and subcontractor trusts.

Review of Security of Payment by R V Gyles, QC

In his review prepared in April 1996, RV Gyles, QC restricts his comment on the constitutional validity of the proposal and does not deal with all the legal and practical ramifications of the complete SOPC proposal.

Gyles comments on two issues:

a) the trust concept
b) the constitutional validity of the proposal

He advises that:

- the trust concept as a basic principle is sound, but "a policy question as to whether administration of the proposed scheme would not be improved by an obligation to keep monies fixed with the trust in a separate account of the type kept by solicitors, real estate agents and so on". In other words each trustee would have to keep at least two accounts namely for general trading and a trust account.

- constitutional issues relating to bankruptcy and corporations law would not invalidate the scheme

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Comment on viability

Comments on viability

Introduction

The following are our comments on the viability of the SOPC proposal. In formulating our comments and views we have considered the report prepared by Andersen Consulting, the commentaries on legal issues provided by Davenport and Roger Gyles QC, the SOPC response to the Andersen report and the comments that we have extracted from the interview process undertaken with participants as well as the legal commentary and views of Deacon Graham & James, Solicitors

Deemed trusts

The centre piece of the SOPC proposal is to legislate that that monies held as a consequence of a payment of a certified claim in a construction contract are deemed to be held in trust for those parties that have provided goods and services to the contract which make up the constituent parts of the claim. The concept of cascading trusts is where the monies, as they flow through the supply chain, are held in trust for each person at the next level down the supply chain.

The viability of this proposal must be considered in light of the benefit to the industry participants that this initiative will give as against the cost.

Benefit/Cost

The incidence where monies are misused or diverted and which result in a loss being sustained by claimants to those monies are not considered significant in the context of the total industry activity. However, it is recognised that losses have and continue to be suffered by participants in the industry where one of the participants, at whatever level in the supply chain, incurs a loss which it cannot sustain within its own financial resources. The potential result is that suppliers to the participant do not receive full (if any) payment for the debt. The reason for losses being suffered are many, including lack of adequate capital, financial management, poor job costing and external factors. The SOPC proposal does not seek to address any of these issues. The capacity to successfully achieve the stated aims of the proposal being to secure payment or prevent monies from misuse is far from certain if the proposal is enacted.

Legal issues

It is our view that the SOPC views which were expressed in their initial proposal and in the response to the Andersen report, that the deeming trusts is not a legally complicated initiative is a simplistic assessment. The legal issues, both in terms of creating the legislation and its subsequent operation have the potential to be very complex.

Philip Davenport stated that federal legislation, in particular the Corporations Law and Bankruptcy Acts, will require amendment to ensure the priority claim to monies.This may be the case, as the proposal seeks to remove the "trust monies" from the control of the liquidator, therefore precautions will be irrelevant. However, ammendment may be necessary to ensure that the trust proposal seeks to give relevant claimants is enforceable without question against all other creditors, for example in cross border issues. It is our view that that to be effective, Federal Government support is neccessary.

Complex legal issues will also need to be considered when formulating the legislation which would give affect to the SOPC proposal. There is clearly uncertainty as to the full legal integrity and practicality of this aspect of the proposal. The time and costs that would be incurred in thoroughly investigating and resolving (if possible) all possible legal issues, may be difficult to justify given the uncertainty as to the ultimate benefit of the trusts as an effective mechanism to secure payment to all participants within the construction industry.

The practical application of the SOPC proposal when a breach occurs raises some specific legal issues which the proposed legislation would need to address such as:

- What money is trust money? That is, with numerous payments being made into a trade account as opposed to a separate trust account, there will be a need to identify trust monies. Costs may be involved in the tracing exercise which is inherent in the operation of trust laws.

- Which party in the supply chain is entitled to the trust money? That is, in the event that a claim may be short paid, who will be entitled to the money from that claim if there are more than one claimant.

- The precise point in time when the trust crystallises. That is, in the case of a bankruptcy, each subcontractor will need to identify when their claim was lodged and to what extent is it going to get priority over another trust claim.

- Where monies are held and a third party such as a contractor from another contract is seeking to claim funds held in the combined account of the contractor. How will this be provided for ?

- Does the principle of acting in good faith apply ? If a director of a company , being a builder or subcontractor acts in good faith in relation to the monies that he has received, is he to be held liable if the beneficiary suffers a loss as a consequence of his actions ? This could be the case where a contractor may need to utilise trust monies to pay a critical subcontractor to ensure the project continues for the benefit of all parties who have an interest in that project.

- Uncertainty may be caused by the application of the law of trusts to the law of contract.The contract chain has as its central philisophy the objectives of keeping parties to a contract at arms length and a trustee will have to avoid conflict between its own commercial interests on one hand and its duty to trust beneficaries on the other.

To ensure that the proposed legislation would deal with these very practical issues in a proper manner will, in our opinion, be very difficult. The aim would be to ensure that the legislation is sufficiently comprehensive to minimise the potential for relevant parties to litigate over the application and enforcement of the legislation in circumstances where breaches have occurred. This in itself will not prevent costs being incurred in parties challenging and seeking court interpretation of the effectiveness of the proposed legislation.

Conclusion (legal)

Accordingly, given the extent of legal difficulties, both in a legislative and practical sense and the potential benefit to the industry of such legislation, it does in our view raise serious questions about the overall viability of the core aspect of the SOPC proposal. The SOPC response to the Andersen report acknowledges that the deeming trust proposal will not guarantee payment to participants but rather, will offer a greater incentive for the participants to deal with monies in the appropriate manner.

The proposal with all the potential legal difficulties is not practical. Moreover, there already exists in legislation such as Corporations Law, Trade Practices Act and the Oaths Act, incentives for proper behaviour in commercial relationships. These may need strengthening or be "policed" more effectively.This would be easier and achieve the same result as the SOPC proposal.

In relation to the Andersen report on the legal viability, we note that their assessment is quite detailed and specific. A number of their comments were challenged by the SOPC Committee in their response. In both instances, we can identify merits and weaknesses in the respective approaches taken.

Commercial issues

One of the stated aims of the SOPC proposal is to reduce the likelihood of monies being misused or diverted from those parties who are entitled to them in the context of the supply chain to a construction contract.

The commercial relationships which have been established and exist between the participants in the construction industry operate reasonably effectively. The majority of participants would seem to have a good commercial relationships. The terms of the relationship between participants will vary from contract to contract and will be impacted upon by a number of factors, contractual, legislative and commercial. The SOPC proposal aims to impose by legislation a certain factor in the relationship between the participants in the industry. There is the potential for this proposal to add a further complication to the commercial relationships which may then give rise to more causes for dispute between participants.

The Andersen report highlighted a number of economic/commercial impacts of the proposal. These included potential for increased costs in the industry, adverse impact upon how financiers will view projects or financing participants in the industry.

The SOPC in its response rejected the findings of Andersen Consulting largely for the reason that they considered Andersen had either misinterpreted the operations of the proposed scheme or were utilising incorrect data in supporting their conclusions.

In our view, the perceived simplicity of the deemed trust proposal is, in a commercial sense, too simplistic. We see the proposal of deeming trusts as providing the potential for adding additional complexities to the commercial relationship between participants in the industry, and for little real or certain benefit.

It is worthwhile taking initiatives which are designed to address the current deficiencies that exist within the industry and its culture but these solutions generally are not successful if they are based on a legislative initiative to impose upon all participants the manner in which they are to transact business between each other.

It is our view that the benefits of the trust proposal will be hard to achieve when it will be relied upon by a participant. This is best illustrated as follows:

Insolvency scenario

Facts:

- Head contractor (HC) has 4 contracts in progress and is awaiting final payment on 3 completed contracts.
- HC has engaged 20 sub-contractors on 4 contracts. Sub-contractors have 100 suppliers who they owe money to in relation to the contracts
- HC has 30 non-contract related creditors such as landlord, bank, utilities and employees.
- All monies received by HC are banked into one account. All payments are made from this account.

- Assets of HC are debtors (unpaid claim), work-in-progress, plant and equipment.

- HC is placed into liquidation and liquidator realise all assets. He has $1m funds to meet, $5m of liabilities.

Creditors Position

Currently

- The $1m would be distributed to all direct creditors of head contractor, in accordance with Corporations Law relating to priorities, eg. employees of head contractors first (excludes employees who are directors), and then secured and unsecured creditors. Suppliers to subcontractors have no direct claims to HC.

Under Trust Proposal

- Potential for dispute between direct subcontractor and non contract creditor as to who's money is the $1m.

- Are all subcontractors and non contract creditors entitled to monies if plant and equipment is purchased by the trust ?

- Will the 100 suppliers be able to claim against HC ? Do suppliers share in funds or make trust claims on monies to step ahead of non-contract and subcontractor creditors?

- A tracing exercise will be required for all 20 subcontractors and 100 suppliers to identify trust monies

From a practical point of view, the trust proposal will cause significant arguments between claimants to the funds when they seek to rely on the deemed trust. This will not only add to the cost of sorting out the problem, but could cause significant delay in achieving the distribution of the funds.

Therefore, from a commercial and practical point of view, when the effect of the deemed trust is most required and its greatest benefit is to be evidenced, the benefit could in fact be lost in meeting the costs of sorting out the many issues.

Conclusion (commercial)

Our view is that from a commercial point of view, whilst the concept of a deemed trust is theoretically sound and simple to implement, the effect of such a change on the commercial relationships and operations of the industry are unknown. Therefore, the potential to create more problems and the scale of those problems are such that we do not see the benefit outweighing "the potential commercial costs of this initiative". We see this as going to the very core of the viability of this aspect of the SOPC proposal.

Shortened payment cycle

The SOPC has part of its proposal also recommended that initiatives be taken to shorten the payment cycle between participants within the industry. In particular, the Committee was very concerned at the degree to which subcontractors are exposed by having an obligation to continue to provide goods and services under its contract without payments being received for work or services provided.

The Andersen report made considerable comment to this issue. In particular it considered that the shortening of the payment cycle could add costs to projects as it removed "free capital" from the cashflow pipeline operating within the industry. It acknowledged that this free capital is largely available to the parties at the head of the supply chain, being head contractors, builders and owners but other parties lower down the supply chain could also have access to a reasonable amount of free capital.

The SOPC in their response state that the concept of "free capital" was morally reprehensible. It should be addressed.

It is our view that it is questionable that "free capital" exists. What the current payment cycle of the industry does permit is certain commercial leverage to be applied at various stages which would result in certain participants taking extended credit terms where they are not otherwise provided. In essence, it is not an issue of "free capital", it is more an issue of which participant or participants will bear ~~bare~~ the funding costs of the particular project. By funding costs it is not only meant the funding costs that the owner will incur but the costs that each participant incurs in the operation of its own business which it would

seek to build in to its pricing on the project. On this basis, the SOPC response is justified.

The terms of the payment cycle as explained by both Andersen and SOPC, in our view causes the greatest pressure on the industry participants particularly those at the lower level of the supply chain. We agree with the Andersen view that the payment cycle issue is a more critical issue in terms of the general efficiency and operation within the industry.

The principles put forward by the SOPC should be carefully considered and implemented largely through imposing the appropriate conditions in standard contracts. This initiative would in itself lessen the likelihood of funds being misused and redirected. Moreover, it would also contribute to creating an environment where those participants who may be experiencing financial difficulties could be identified on a more timely basis to enable appropriate action to be taken to avoid or minimise the losses suffered.

Other proposals / initiatives

The SOPC and Andersen Consulting both made further recommendations in relation to other initiatives which could be taken to improve the industry thereby minimising the incidence of misuse of monies and loss suffered by participants. These addressed issues such as enhancing the alternative disputes resolution process to enable disputes to be resolved in a cost effective and efficient manner, strengthen current legislation such as for making false statutory declarations and improve financial/management training. SOPC does support in its response some of the initiatives that Andersen have proposed.

Information rights

The right to information provisions in Section 3 of the SOPC proposal are included to enhance the effectiveness of the trust proposal.

Issues such as giving the beneficiary of a trust a right to inspect and obtain information in relation to details of contract, including contract price, state of accounts between owner and contractor and labour and material payments bonds would in our view be difficult to legislate for. It would add considerable complexity to the general commercial relationship that exists between participants. In relation to some legal aspects, the proposal would be against the legal principle of confidentiality of contractual information between parties.

Secondly, the proposal to extend liability for breaches of the right for information provisions to what could be unrelated parties will be very difficult to legislate properly within the generally accepted principles of contract and law of equity. This will be further complicated when the proposal is seeking to engage the Court in enforcing compliance with the proposed provisions of this part of the proposal.

The aspect in relation to right to information to the extent that it is an integral part of the trust proposal will, in our view, add further complications and we question the ultimate effectiveness.

Therefore, the cost and time that will need to be spent to resolve the detailed issues that we have raised is very difficult to justify in light of the uncertainty of the benefit of that the proposal will bring.

Summary of comments

The SOPC proposal as stated in their document is not, in our view, a viable proposal. Whilst the proposal seems to provide a simple, easy to implement and effective solution to achieve the aims of ensuring that monies are treated in the appropriate manner within the industry, its viability is very questionable for the following reasons:

- The legislation to bring in affect the proposal will potentially be very complex and will need to be drafted with consideration to a number of other federal and state acts and laws which are currently in existence. For example, the Corporations Law, Bankruptcy Act.

- The legislation to implement this proposal may give cause for more litigation arising from disputes caused through the desire of participants to exercise the rights envisaged to be given to them under the legislation. As with any new piece of legislation, litigation is the way to establish how that legislation will be interpreted in the many different circumstances to which it may be applied. The likely result of this is that more costs will be incurred by industry participants in dealing with issues arising from the creation of this legislation. To impose by legislation terms of relationship between parties which have always been based on contractual and general commercial arrangements is unlikely to have any real effect unless the capacity to enforce the rights and the penalties associated therein are sufficiently strong.

- The proposal seeks to break down aspects to commercial relationships which would, for a number of reasons, be resisted by the participants in the industry. This is particularly in relation to rights to information.

- At best the proposal will only provide an additional incentive to incentives already in place for participants to act in a proper and commercial manner in their dealings with other participants in the industry in relation to the payment for goods and services rendered. There are too many other factors that operate within the industry which will result in monies not being received in particular circumstances by the rightful recipients. Nothing in this proposal will alter that situation.

- This proposal may also result in making more complex the resolution of the position where insolvency occurs and there are insufficient funds to meet all obligations. It will certainly add to the costs of sorting out the issues.

- The certainty with which the benefits of the SOPC proposal will be enjoyed by the industry is very questionable. Given this, it is hard to justify the incurring of significant costs and creating further potential complexities which this proposal may bring.

- The existing legal system does have in it a number of incentives for operators in the industry and in commerce generally to act in a proper and fair manner. Provisions including the duties and responsibilities of directors contained in the Corporations Law, provisions in the Bankruptcy Act in relation to incurring debt without reasonable expectation of being able to pay it as well as various other provisions specific to compliance with industry specific acts could all be enhanced to provide equally as much incentive to the participants in the industry to act with propriety and not misuse or redirect monies.

5

Way forward

Symptoms of a larger problem

Symptoms of a larger problem

Whilst the object of this report is to summarise and comment on existing recommendations, Coopers & Lybrand and Deacons Graham & James have been requested to suggest how the security of payment issue might be progressed.

It is considered by Coopers & Lybrand that failure to be paid is another symptom of problems associated with ethics, management skills, financial strength and culture through the construction industry.

Some progress

On a more positive side, in the past five years significant progress has been made via a combination of:

- the Building Industry Royal Commission
- NSW Government Code of Practice for the Construction Industry
- innovative project structuring such as Build Owner Operate and Transfer (BOOT), and Design & Construct
- builders, subcontractors and suppliers providing longer warranties and accepting ongoing maintenance obligations
- low dispute contractual frameworks such as the Glebe Island Bridge contract
- Introduction of concepts such as co-operative contracting
- Corporations Law being improved to deal with insolvent trading.

Appropriate drivers

The progress made on some projects does indicate a way forward.

Where appropriate drivers have been established to encourage good practice, there has been a strong incentive for all concerned to work together and achieve best practice outcomes.

Under such circumstances, more significant changes in culture are possible than by attempts to strongly regulate the industry.

An example of an appropriate driver might be when an industry rating scheme was established to rate capability, professionalism, risk, expertise and experience. If the rating system was used by the insurance and financial services industries to differentiate premiums and the cost of funds, as well as government to award work then there would be a strong driver for organisations to improve their performance.

Next steps

These steps listed have been developed to improve the culture, professionalism and competitiveness of the industry

These include:

- progress related topics such as increasing penalties for making false or misleading statements in statutory declarations.

- look at good examples of successful projects to determine correct drivers, for example, ratings for awarding contracts based on previous performance and the establishment of differentials for cost of funds and credit ratings

- determine a vision for what should be best practice for the industry with respect to:
  - commercial viability such as capitalisation
  - rating system to rank best practice
  - subscription to electronic funding transfer systems
  - culture
  - application of incentives, etc
  - appropriate internal systems including some computer based systems

- determine how these drivers may have affected companies that have been liquidated eg. Girvan

- look at the best way to implement the drivers

- the NSW State Government continue to monitor factors affecting the cyclical nature of the construction industry with the aim of moderating and influencing the industry

- review options to introduce long term contractors

Document 5

Philip Davenport on behalf of the Construction Payment Group

Response to Clayton Utz' comments on draft amendment to the Contractors Debts Bill relating to statutory trusts

CONSTRUCTION PAYMENT GROUP

RESPONSE FEBRUARY, 1998

SUBMISSION BY CLAYTON UTZ ON BEHALF OF:

AUSTRALIAN CONSTRUCTORS ASSOCIATION

PROPERTY COUNCIL OF AUSTRALIA

HOUSING INDUSTRY ASSOCIATION

MASTER BUILDERS' ASSOCIATION

METAL TRADES INDUSTRY ASSOCIATION

On the basis of an equitable arrangement that there can be no doubt that all parties agree with the Chairman's remark that everyone is entitled to a "fair days pay for a fair days work".

The outstanding issue for this to be achieved is the implementation of a suitable legal framework.

It is obvious that some sectors of the industry have fear for their own commercial consequences in the achievement of a just and equitable solution.

We live in a changing world. New systems of financing have accompanied the changes in building technologies with the major work being undertaken by subcontractors. It is of fundamental importance that those persons (workers and subcontractors alike) should get paid for the work they undertake. That after all is social justice.

Legislation to secure payment does exist in other countries and the need for such systems have already been identified.

The response which follows should suffice to illustrate that from a legal and practical aspect, there are no impediments in the Proposal that would interfere with legislation.

Response of the Construction Payments Group to Clayton Utz comments on draft amendments to the Contractors Debts Bill relating to statutory trusts

1. Introduction

1.01 This response is to the undated 31 page document which is attachment 2 to the letter of 4 February 1998 from the Director of the Joint Standing Committee upon Small Business.

1.02 It comprises this introduction and a paragraph by paragraph response to Clayton Utz' Executive Summary and 88 paragraph detailed commentary on the proposed amendments to the Contractors Debts Bill 1997 relating to statutory trusts.

1.03 So far as Clayton Utz' comments are confined to matters of law, some are correct, but to argue that legislation that has worked successfully in other jurisdictions for more than half a century won't work flies in the face of the evidence and suggests that Clayton Utz have conducted limited research.

1.05 The main thrust of Clayton Utz' comments is that the proposed legislation is "too simple" [paragraph 7] and that "exceptionally detailed legislation" is required [paragraph 88] to remove the uncertainties which Clayton Utz have about how the legislation will operate. Those uncertainties are answered below. If the trust amendments are passed, the Construction Payments Group will publish a brochure for contractors and subcontractors detailing their responsibilities. The purpose of legislation is to create law. It cannot detail every possible eventuality and the rights and obligations of people is every conceivable situation. Legislation should be kept simple.

1.06 If, when the Australian Constitution was being drafted, it had been decided not to proceed because some lawyers found some uncertainties, Australia would still be six colonies. There has not been an act of Parliament in which no lawyer could find an uncertainty. There is no legislation which details every possible eventuality and the rights and obligations of people is every conceivable situation. Where words are your medium, debate is always possible. However the Amendments follow very closely, sometimes word for

word, legislation which has stood the test of time in other jurisdictions.

1.07 While raising questions, Clayton Utz offer no answers except "exceptionally detailed legislation". With respect, contrary to what Clayton Utz say in paragraph 7, legislative experience elsewhere has not shown that "considerably more detail is required". The draft is simple because it does not attempt to achieve as much as legislation in other places. The Saskatchewan Builders' Lien Act 1984, an example of Canadian Legislation, has 16 clauses compared to the 6 in this draft. But it extends to owners as well as contractors and it covers proceeds of insurance, consideration other than money and penal provisions, all of which have been excluded from the draft in order to keep it simple. "Exceptionally detailed legislation" is not required.

1.08 If the Construction Payments Group had proposed "exceptionally detailed legislation", as suggested by Clayton Utz, no doubt the criticism would be that it is "exceptionally detailed".

1.09 It may be that minor amendments could improve the present draft but Clayton Utz offer no constructive proposals. Once the legislation is accepted in principle, consideration can be given to changes in detail. Clayton Utz' comments can be summed up in four words, "Its all too complicated". The Construction Payments Group does not agree.

2. Response to Clayton Utz' Executive Summary

Paragraph 1 - No comment required except to note that Clayton Utz were apparently not asked to recommend amendments to overcome perceived problems.

Paragraph 2 - The alleged assertions are not the assertions of the authors of the amendments.

(a) Clause 15 of the draft specifically refers to separate trust accounts for each person against whom retention or cash security is held. Trust accounts can be kept separate without opening a multitude of separate bank accounts. The legislation will not impose any additional administrative burden on a contractor who already keeps proper accounting records for each project.

(b) Contractors should know that trusts exist. That is the whole purpose of the proposed legislation. But the legislation will not require a contractor to do anything which a contractor should not already be doing. The purpose of the legislation is to require those contractors who are not doing the right thing by their subcontractors, to do the right thing.

(c) The proposed legislation is intended to prevent contractors passing subcontractors' money between projects thereby leaving the subcontractors unpaid. It is to stop the contractor using Peter's money to pay Paul. The contractor can pass the contractor's own moneys between projects but not a subcontractor's moneys. For the contractor who pays subcontractors on time and using the contractor's own funds or funds received from the principal on the respective project, the legislation will be "invisible".

(d) The proposal is intended to put a stop to some iniquitous practices which, unfortunately, are so common that they could be labelled "normal commercial transactions". If the legislation did not interfere with any commercial transactions whatsoever, it would serve no purpose. The legislation does not interfere with what should be normal commercial transactions. It is intended to enforce what should be the norm.

On p.30, in commenting on the "authors' assertions" Clayton Utz claim that "The industry will be pervaded by legal uncertainty and subject to burdensome administrative requirements". With respect, this is not borne out by any empirical

evidence whatsoever and runs contrary to experience in other jurisdictions and such empirical evidence as does exist. The "legal uncertainty" to which Clayton Utz refers only exists in because Clayton Utz has not researched the subject sufficiently. The "burdensome administrative requirements" are a figment of the imagination. They are not a product of the proposed legislation.

Paragraph 3 - No comment required

Paragraph 4 - The proposals are brief. Every effort was made to make the legislation as simple as possible. Brevity was not achieved by accident. It was the result of thorough research and skilled legal work.

(a) Clayton Utz correctly conclude that the law of trusts applies. That is consistent with legislative approaches in the United States and Canada. The proposals are not intended to change the law of trusts. Granted, many "participants in the industry" do not know anything about trusts. No doubt various industry bodies will organise seminars to educate their members on their obligations under the legislation. The proposed legislation does not "defy commercial reality" or lead to "extraordinary commercial consequences and additional and complex administrative burdens". Clayton Utz do not provide any illustrations to back up these sweeping allegations. The administrative obligations on contractors and subcontractors are minimal and are no more than they should be performing even in the absence of the legislation.

(b) If the definition of "contractor" or "improvement" can be improved, let there be constructive suggestions. If there is any imprecision, let it be identified. The only other "range of industries" identified by Clayton Utz is "contract gardening and cleaning work" [paragraph 17]. Landscaping, decoration, repair and maintenance" are specifically included in the definition of "improvement" but it would be stretching the definition to suggest that mere gardening or cleaning was making a "change to land or anything erected on or under land". However, if this is a real problem, the draft definition can be amended.

(c) This is covered under paragraphs 24 to 29 below. Examples of how the legislation will work are scattered throughout this response and, in particular, in response to paragraph 42. The proposed legislation will not prevent or resolve disputes between owners, contractors and subcontractors over what is owed by one to the other. The trust applies to amounts owed but it does not resolve a dispute over how much is owed.

Paragraph 5 - Clayton Utz are quite correct. The proposed amendments are intended to have significant consequences in the event of insolvencies. They are intended to ensure that an insolvent contractor's assets available for distribution to secured and unsecured creditors do not include amounts paid by the owner to the contractor for work done or materials provided by a subcontractor. The statutory priorities which will be most affected are those of lenders from whom the contractor has borrowed moneys on the security of amounts which properly belong to subcontractors. Workers will actually receive greater protection from the trust legislation than they presently receive on a winding up.

Paragraph 6 - Clayton Utz believe that the only way the objectives can be achieved is through "exceptionally detailed legislation" [paragraph 88]. The disagreement is not over whether the objectives can be achieved but only over how much detail is required in the legislation. The difference is over the detail not the substance.

3. Response to Clayton Utz' Detailed Comments

Paragraph 1, p.1

Clayton Utz say, "so far as we are aware, the industry has not had an adequate opportunity to consider or comment on the Amendments".

The Amendments have been in the public domain for over 7 years. In 1992, the Amendments were published in the Australian Construction Law Newsletter [Issue 24, pp.39-40] in an *Outline Draft for a Construction Industry Trust Act*. Mr. Davenport provided that draft act to Anderson Consulting when they were preparing their 1993 report. He discussed how it would work and Canadian experience. The Department of Public Works and Services provided it to Coopers & Lybrand when they were preparing their 1996 report. The industry has had ample opportunity to consider the Amendments. It is unfortunate that neither Anderson Consulting nor Coopers & Lybrand analysed the present proposal. They have both made assumptions about trusts and jumped to conclusions without any detailed analysis.

It seems that the very word "trusts" scares people. They envisage some complicated legal arrangement, forgetting that almost everyone is a trustee at one time or another, even if it is only of their children's piggy bank savings. A trust is simply the relationship which exists where a person holds title to property that belongs to another.

Strictly speaking, the various obligations of a trustee, eg. efficient management, loyalty, keep and render separate accounts, act personally, account for interest, etc. referred to by Clayton Utz apply to the parent or guardian minding a child's money. But, in reality, those obligations are not onerous and are performed in the ordinary course of events without fuss. Similarly, the trust obligations created by the Amendments can be performed without fuss.

Paragraph 2 - No comment required.

Paragraph 3 - No comment required.

Paragraph 4

(a) to (e) - No comment required.

(f) As mentioned above, the alleged assertions are not those of the authors of the Amendments.

(g) Clayton Utz conclude [p.31] that there is no simpler way.

Paragraph 5 - No comment required.

Paragraph 6

The alleged legal uncertainty can be resolved by legal research. There is a body of case law in the United States and Canada on arguments which are likely to be thrown up.

The practical uncertainty can be resolved by a campaign to educate contractors and subcontractors about their responsibilities.

Paragraph 7

Clayton Utz say that the legislation is too simple. The argument is usually that legislation is too detailed. Clayton Utz say that only "exceptionally detailed legislation" will achieve the objective [para 88]. Clayton Utz say that their research "and legislative experience elsewhere suggests that considerably more detail is required". With respect, an examination of legislation in other jurisdictions will show that it is as simple as the proposed Amendments.

In the United States and Canada there is a long history of lien [usually called "mechanics lien"] legislation. Generally speaking, the trust legislation is a few sections in the lien legislation. In the New York *Lien Law* it is 10 sections, in the Ontario *Mechanics' Lien Act* it is 7 sections, in the Saskatchewan *Builders' Lien Act* it is 16 sections. The legislation is far from detailed because, as with the Amendments, it relies upon the general law of trusts.

Paragraphs 8 to 15 - No comment required.

Paragraphs 16 to 23 - The Trustee

Clayton Utz quibble over the meaning of certain words. This is pointless if the proposed legislation is flawed in principle. If the legislation is basically sound then consideration can be given to amendments to definitions and exempting particular categories of people from the benefit or burden of the legislation.

For example, there is a precedent [s.11 of the Saskatechwan *Builder's Lien Act*], for permitting a contractor who has paid subcontractors out of moneys other than trust moneys to retain from the trust fund an amount equal to that payment. This would overcome the difficulty illustrated in paragraph 20. If a contractor pays the subcontractors not out of money received by the contractor pursuant to a construction contract but from moneys which are the contractor's own moneys [albeit borrowed from a financier], the contractor could validly charge the moneys received from the principal with the amount paid to the subcontractors.

Under the New York *Liens Act*, section 73, there is provision for a "Notice of Lending". This is a formal notice which is filed in the office of the local county clerk. It records a loan by a financier to a contractor and permits the financier to charge moneys received from the principal to the extent that the loan moneys are actually paid to subcontractors. The Saskatchewan solution is more appealing.

Paragraph 24

Clayton Utz correctly presume that the trust property includes the chose in action.

Paragraph 25

The property which the subcontractor holds in trust for the workers and suppliers of the subcontractor is the subcontractor's contractual right to payment by the main contractor [the chose in action] for carrying out the work and moneys received for carrying out that work. Whether the moneys received are from moneys impressed with the trust [ie. moneys paid by the principal to the contractor] or elsewhere is irrelevant.

The subcontractor does not have a right to a particular portion of the moneys impressed with the trust. The subcontractor has a right to require the trustee to administer the trust moneys in accordance with the law. In considering s.19 of the *Mechanics' Lien Act* of British Columbia, which section is the equivalent of section

14 of the Amendments, the Supreme Court of Canada held:

> S.19 does not, however, require that they [the moneys received by the sub-contractor from the main contractor] be distributed on a pro rata basis. The sub-contractor has, in this respect, a discretionary power, and his obligation is satisfied when the trust moneys are paid out to persons entitled whatever the division. This, of course, might be affected by rights of unpaid trust creditors under other provisions of law. [*Minneapolis-Honeywell Regulator Company v Empire Brass Manufacturing Company* (1955) SCR 694, per Rand J at 697].

The situation alluded to in the last sentence would arise when the contractor is insolvent and there is a trust fund insufficient to pay all the subcontractors. They would then be entitled to share rateably.

For example, if the principal pays the contractor $50,000 and the contractor owes subcontractor A $50,000 and subcontractor B $25,000, the contractor can pay the whole $50,000 to subcontractor A without breaching the trust obligation. But if the contractor is insolvent and the only asset is $50,000 owed by the principal then contractor A and contractor B are entitled to share the $50,000 in the ratio of 2 to 1. The difference arises because, on insolvency, the Federal insolvency laws come into play.

Para 26

Clayton Utz ask, "How is it to be determined whether an amount is owed? Who is to determine that? Those questions will be answered as they are now. In this regard, nothing will change. The Amendments do not interfere with or change the contractual process for determining what is owed and who is to determine disputes. The parties in the contractual chain are free to arbitrate, litigate, mediate or use an other method or alternative dispute resolution to determine how much is owed.

Paragraph 27

The whole right to payment of the contract price is a chose in action which is impressed with the trust. This includes the right to receive, in due course, any unpaid portion of the contract price. Whether the right of a contractor to payment by the principal is dependant upon a certification by a superintendent [AS2124 and

AS4000] or an architect [JCC] is irrelevant. The question is whether there is a right to payment. How the right arises is irrelevant. Whether the right is dependant on prior certification or whether it exists without a certification, it is the right [the chose in action] which is impressed with the trust. If a contractor has no right to payment then there is no trust over the non-existent right.

To relate the trust to amounts certified would lead to ambiguity, as rightly identified by Clayton Utz in paragraph 26. For that reason, the Amendments make no mention of certification.

Paragraph 28

(a) "Delay costs" is not a legal term. Usually what are commonly described as "delay costs" are amounts which the contractor claims as reimbursement for work done, eg. additional on site overheads. But sometimes the claim is a claim for damages for breach of contract. It is conceivable that in an usual case, those damages may not be for carrying out an improvement but for income foregone on account of being prevented from carrying out other work. In that case, they would not be impressed with the trust. Each case would have to be considered on its merits.

Another example would be money payable to the contractor as damages for misleading or deceptive conduct. The damages need not be for carrying out an improvement. Then they would not be impressed with the trust.

However, a problem would only arise when the contractor is insolvent and unable to pay subcontractors but there are moneys owed by the Principal for breach of contract, breach of statute, tort or other wrong outside the contract. Then there may be a dispute between the liquidator and the subcontractor as to whether those damages are amounts owed for carrying out the improvement or on some other account. Such a dispute is a very remote possibility and there is no way that the legislation can envisage and cater for every possible factual situation which could conceivably arise.

Paragraph 29

The Amendments do not distinguish between individual schedule of rate or bill of quantities items making up the contract price. Even if a part of the contract price can be labelled "overheads" or "profit" or "bonus", it is not exempted from the trust.

Clayton Utz say that the contractor is excluded from the benefit of the trust even where the money may not relate to work provided by a subcontractor. The trust is not for the benefit of the trustee. If amounts received by the contractor for work done by subcontractors are insufficient to pay subcontractors, then they are entitled to have recourse to any moneys received by the contractor from the principal on account of the contract price whether those moneys are labelled "overheads" or "profit" or "bonus".

If, in the contract with the principal, the contractor has not allowed sufficient to cover both the contractor's margins and profit and the amounts payable to subcontractors, that is the contractor's problem. The contractor has underpriced the work. On the other hand, if the contractor has properly priced the work and the principal wrongfully withholds payment then the contractor's remedy is against the principal. The contractor is not entitled to take his margins and profit and leave the subcontractors to bear the loss. The contractor must pay the subcontractors before taking any amounts on account of margins, profit or bonus.

Paragraph 30

(a) and (b) - No comment required.

(c) It is not apparent how the construction trust could "potentially complicate" employment relations. If employees are paid on time, they would not even know of the trust obligations. If the contractor is unable to pay them, they may be very grateful for the existence of the trust. It may provide a fund from which they can be paid where otherwise they would miss out.

(d) If the unpaid supplier cannot identify the goods or services supplied with the project in respect of which the trust moneys are held, the supplier would not be a beneficiary. For example, the hardware store which provides paint may have difficulty proving what the paint was used on any particular project. But if the unpaid supplier can show that the paint was used on a particular project, the unpaid supplier is entitled to the benefit of the legislation. The issue raised by Clayton Utz is whether the words "for the purpose of carrying out the improvement" qualify the words "have provided" or the words "materials or services". It is submitted that the the latter is the correct interpretation. It is submitted that even though a subcontractor or supplier is ignorant of use being made of the subcontractor or supplier's services, they are still entitled to the benefit of the trust. However, if it is

thought that there is ambiguity, a minor amendment would remove it.

Paragraph 31

The Amendments do not require a contractor to create or maintain any records or accounts which a competent contractor would not already be maintaining. A competent contractor would be maintaining separate accounting records on each project. Those accounts would show all receipts and all payments and would separately identify as moneys held in trust any cash security or retention moneys. The entitlement of each subcontractor to those trust moneys [retention and security] would be separately identified.

The individual subcontractors do not have an individual share in the moneys which are held in trust under section 14. Those moneys would usually only comprise progress payments. There would be one trust account for progress payments, not a separate trust account for each person entitled to share in the progress payments.

There is a distinction between a "fund" and an "account". The contractor must separately record for each project moneys received and moneys paid. The moneys received on a project are impressed with a trust in respect of that project only. The contractor cannot have one trust fund for all projects but the contractor could have one bank account.

Moneys received by the contractor on project A are not impressed with any trust for subcontractors on project B. Once all subcontractors on project A are paid in full, any moneys received by the contractor on account of project A are available to meet any liabilities of the contractor and, subject to the right of any secured creditors and preferential creditors, they are are available for distribution to ordinary creditors even though subcontractors remain unpaid on project B.

However, if an insolvent contractor has not kept separate records of receipts and payments on each project, and there is no way of telling whether the moneys remaining in the contractor's hands were received on project A or project B, then it is quite likely that they will be impressed with a trust in favour of all unpaid subcontractors.

Para 32. No comment required

Para 33

These questions are answered by the Supreme Court of Canada's decision in *Minneapolis-Honeywell Regulator Company v Empire Brass Manufacturing Company* (1955) SCR 694, referred to above. The trustee has a discretion as to how the trust moneys will be divided between beneficiaries. A beneficiary does not have a proportionate share in the trust fund.

Para 34

The general law of trusts will apply. The statutory scheme does not override contractual rights and obligations.

Para 35 - The general law of trusts will apply.

Para 36 and 38 - No comment required.

Paragraph 39

It is important that the question of whether an amount is owed to a subcontractor for work, materials or services supplied by the contractor or on some other account is not left to the whim of the contractor but is determined objectively. Otherwise, a contractor could defeat the purpose of the legislation by paying a particular [friendly] subcontractor more than is owed. The fact that a contractor settles a claim without admission of liability does not determine whether or not the settlement moneys are owed in respect of work or materials.

Paragraph 40

With respect, Clayton Utz have misinterpreted the Amendments. As stated in response to paragraph 25, there is authority from the Canadian equivalent to the Australian High Court, to support the proposition that the Contractor does not have to treat beneficiaries equally [see paragraph 25].

Paragraph 41

It is correct that while subcontractors on project A are owed moneys, the contractor will not be able to use moneys received from the principal on project A to pay subcontractors on project B. The contractor must keep the accounts of each trust separately. Similarly, while moneys are owed to subcontractors on a project A, the contractor cannot use moneys received from the principal on project A to pay the contractor's overheads or profit. The trust only attaches to the net amount due to subcontractors for work properly done by them as contemplated by the contract with the principal [*United Metal Fabricators v Voth Bros. Construction* (1974) 42 D.L.R. (4th) 193]. As explained in response to paragraph 29, the shortfall is either due to the contractor's underpricing or the principal's underpaying. It is not the fault of the subcontractors.

In a smooth running contract, each progress payment received by the contractor will be sufficient to pay the workers, subcontractors and suppliers for the work done and materials supplied in the period covered by the progress payment, with sufficient left over to cover the contractor's overheads and profit. But if the project is running at a loss, and the contractor complies with the trust obligations, it will be the contractor who first feels the pinch. As Coopers & Lybrand rightly identify [page 27 of their August 1996 report], the trust legislation will:

> contribute to creating an environment where those participants who may be experiencing financial difficulties could be identified on a more timely basis to enable appropriate action to be taken to avoid or minimise the losses suffered.

While a contractor must keep separate accounts for each project [trust], the contractor does not need to keep separate bank accounts. The project [trust] account is a bookkeeping record, the bank account is something different. If there is concern that some lawyers or accountants will advise contractors that they will have to open multiple separate bank accounts, a provision along the lines of the New York Lien Law section 75(1) could be included in the legislation. It provides:

> The trustee shall not be required to keep in separate bank accounts or deposits the funds of the separate trusts of which he may be trustee under this article, provided his books of account shall clearly show the allocation to each trust of the funds deposited in his general or special bank account or accounts.

Paragraph 42

The questions raised by Clayton Utz are best answered by a few examples of how the construction trust will work in practice.

Example 1

Assume that there is a contract for construction of a building for $20m. Assume that 50% of the contract work is electrical subcontract work valued at $10m and the balance of the work is carried out by the main contractor.

When the whole of the work is 50% complete, the main contractor makes a progress claim on the principal for $10m. representing completion of 50% of the main contractor's own work and 50% of the subcontractor's work.

Assume that the principal makes a progress payment of $10m. As the law stands, and will continue to be if the trust provisions are not adopted, the whole $10m. is the property of the main contractor and available to meet any debts whatsoever of the main contractor. Although half of that $10m. was for work done by the subcontractor, the subcontractor has no right to that half. The subcontractor is in no better position than any ordinary creditor of the main contractor. If the main contractor is insolvent, the subcontractor will probably get absolutely nothing.

If the trust legislation was in place, half the progress payment of $10m. would be impressed with a trust for the benefit of the subcontractor. That $5m. could not lawfully be taken by other creditors of the main contractor. The main contractor could not lawfully use that $5m. to pay anyone other than the electrical subcontractor for whose work the owner paid the $5m.

Example 2

Assume that a contractor has a construction contract for $10m. Assume that the contractor has eight subcontractors each with a subcontract for $1m, leaving $1m for paying the contractor's own workers and $1m for overheads and profit.

Assume that the first progress payment is $1m. Assume that each subcontractor has done $100,000 worth of work but one subcontractor has put in a progress claim for $150,000. The contractor would pay each of eight subcontractors $100,000, the contractor's own workers $100,000 and would take the remaining $100,000 to use as the contractor pleases.

Although the subcontractor who has claimed $150,000 may claim that the contractor still holds $50,000 in trust, the contractor does not in fact hold any money in trust. The contractor is not in breach of trust. It is only "until all persons for whose benefit the trust is constituted are paid in full all amounts owed to them for work, materials or services supplied by them" that section 14(3) bars the contractor from appropriating any part of the trust fund to the contractor's own use.

Example 3

Now assume that the contractor in the previous example is not sure whether the contractor owes the subcontractor the extra $50,000 or not. The contractor has the choice; the contractor can leave the $50,000 untouched until the dispute is resolved; the contractor can take legal advice and act upon the advice, or the contractor can take the risk of appropriating the $50,000 to the contractor's own purposes.

Assume that ultimately, in arbitration or litigation, the subcontractor is found to have been correct and obtains an award or judgment for the $50,000. If the contractor is solvent and able to pay the judgment, that is the end of the matter. If by then the contractor is insolvent, the subcontractor may decide to try to trace the trust moneys, ie the $50,000 appropriated by the contractor to the contractor's own purposes. It may be that the contractor's director has paid the $50,000 to himself or herself. It may be that the subcontractor can recover the money in an action against the director personally [as for example in *Horsman Bros. v Dahl* (1981) 125 DLR (3d) 404].

It may be that the money can be traced to a bank account and the subcontractor can recover the $50,000 from that account in preference to other creditors. The $50,000 may even be able to be traced into another form, eg. a car purchased by the director with the $50,000.

Obtaining legal advice and acting upon it before appropriating the $50,000 is a precaution which the contractor may take to avoid any possible allegation, when the contractor is unable to pay the $50,000, of criminal misappropriation of moneys.

Paragraph 43

See paragraph 54.

Paragraph 44

With the exception of moneys held in trust in accordance with section 15 [retention moneys and security], the contractor should not hold moneys on trust long enough to earn interest. The moneys should be paid out to the workers, subcontractors and suppliers before they have time to earn interest.

Since no beneficiary has an entitlement to a specific amount of the moneys impressed with the trust under section 14, there would not be a specific amount upon which interest accrues in favour of a particular worker, subcontractor or supplier. The legislation does not impress with a trust the interest received by the contractor from a bank or other source on moneys received from the principal.

However, interest earned on retention moneys and security held by the contractor is trust moneys. Accounting to the beneficiary for that interest should be no problem because each particular beneficiary's moneys can be separately identified.

If, instead of paying a subcontractor the subcontractor's entitlement, a contractor or someone else wrongfully withholds the subcontractor's money and earns interest on it, there is no reason why the person wrongfully withholding the money should not have to account to the subcontractor for that unjust enrichment.

Naturally, the contractor is subject to the same tax laws as anyone else who earns interest. Accepting an unconditional undertaking from a bank [commonly called a bank guarantee] in lieu of cash security or retention is a common practice in the construction industry. It avoids the need for keeping cash security or retention moneys in trust and the need to comply with the tax laws concerning undistributed interest. The tax laws apply now whenever a contractor or principal holds cash security or retention moneys on trust. The Amendments will not change that. The tax implications have not stopped the common practice of including in construction contracts a requirement that cash security and retention money be held in a trust account [eg. clause 5.9 of AS2124-1986 and clause 10.23 of JCC-C 1993].

Section 15 of the Amendments merely enshrines in legislation what is commonly included in subcontracts and what, by the terms of the head contract, the New South Wales Government requires all contractors to include in all subcontracts [the "reflective clauses"].

Paragraph 45

Under section 17, the obligation to provide particulars is only upon request by an unpaid subcontractor. The offence created by section 17 only applies when the contractor has failed to pay moneys due. Of course, the courts have other powers to require people to provide records and section 45 does not detract from those powers. If, even though subcontractor is not owed any moneys, a court considers that the contractor should be compelled to provide information, then that is a matter for the court. The contractor can endeavour to explain why commercially sensitive information should be withheld, but ultimately it is for the court to decide. Section 17 does give an unpaid subcontractor power to ascertain the contractor's contract price. Power to obtain that information is necessary to enable the unpaid subcontractor to pursue rights given by the Amendments.

Paragraph 47

The words, "may have constituted the fund" are to cover records of payments made by the contractor from moneys received from the principal. Only by obtaining this information can an unpaid subcontractor determine if there has been a breach of trust.

Paragraph 48

It goes without saying that "particulars of all amounts" does not leave it open to a contractor to give particulars of only some amounts, namely amounts up to some past date. Of course, the particulars of amounts must be current.

Paragraph 49

The administrative burden only falls upon the contractor who fails to pay subcontractors. A contractor who pays debts when due is not affected by section 17.

Paragraph 50

Subcontractors will know the amounts of their respective claims. They will know whether they have been paid or not. If they have not been paid, they have a right to demand information [see section 17]. Except when section 17 applies, a contractor has no greater obligation to render accounts than exists in the absence of trust provisions. The contractor has no obligation to inform subcontractors of their rights. The rights are created by statute.

Paragraph 51

With respect, the Amendments do not affect the contractual provisions between the beneficiaries. Clayton Utz gives an example of a contractor refusing to pay a subcontractor and asks, "does the subcontractor dispute the refusal under the dispute resolution procedures of the contract or must it commence court proceedings in equity?" The answer is that the subcontractor must follow the procedures of the contract. The subcontractor sues the contractor, not the moneys, if any, in trust. You cannot sue moneys. If after having established the debt by following the contractual procedures, the subcontractor finds that there are no

moneys in trust to meet the debt, or someone is wrongfully withholding trust moneys or has misappropriated them, then the contractor may bring an action against that person. It is a different action to the contractual dispute [see *Fraser Sash & Door v Bevenco Construction* (1960) 35 WWR 124].

However, *Horsman Bros. v Dahl* (1981) 125 DLR (3d) 404 is an example of where the claimant was able to by-pass suing the contractor [and hence the contract dispute resolution procedures] and was able to sue directly the sole officer and director of the contractor for the amounts which the director caused to be wrongfully paid out of moneys received in trust. The case was different because the director was the operating head of the contracting company and could have disputed the validity of the subcontractor's claim but chose not to.

Clayton Utz ask, "Can the outcome of dispute resolution procedures under one regime affect the outcome of the other regime?" The answer is, "Yes". If, in the dispute resolution procedures under the contract, it is found that the contractor does not owe the subcontractor any moneys, or that the amount owed is, for example, $100,000, that decision does affect the rights of the subcontractor in respect of any trust funds. For example, the contractor could not claim to be entitled to $150,000 from trust funds if in the other proceedings the liability of the contractor has been determined at $100,000.

Clayton Utz ask whether a dispute over the trust fund is a "dispute arising out of or in connection with the Contract". A dispute over the trust fund will only arise when the contractor is insolvent. In those circumstances, legal proceedings can usually only be pursued with the leave of the court. It is conceivable that a claim by a subcontractor to a right over certain particular moneys [allegedly held in trust] in the hands of the contractor could be a "dispute arising out of or in connection with the Contract". It would be most unusual but it is not inconceivable.

The Supreme Court in Canada in *Mineapolis-Honeywell Regulator Company v Empire Brass Manufacturing* (1955) SCR 694 at 697 pointed out that a subcontractor does not have any specific or exclusive interest in the trust fund. For example, if the subcontractor is owed $50,000 and the trust fund is $50,000, the contractor commits no breach of trust if the contractor pays that $50,000 to other unpaid subcontractors on the same project. The situation would not arise where the subcontractor can elect between pursuing the contract dispute procedures and suing in equity for $50,000.

Paragraph 52

The two remedies, the contractual remedy and the proprietary remedy are quite distinct. One is a claim for damages. The other is a claim for the transfer of particular moneys. You can't have the second unless you have proved the first. You can pursue both remedies but you must pursue the first before the second. There is the unusual exception illustrated by *Horsman Bros. v Dahl* [above]. See also *Proprietary Claims and Remedies*, Cope, M., Federation Press, Sydney, 1997.

Paragraph 53

In a privately created trust, it is usual to have a trust deed setting out the terms of the trust and the powers of the trustee at some length. However, there is no precedent for, or need for, construction trust legislation to do the same.

(a) Without breaching the trust, the contractor cannot "sign away" the obligation of the principal to pay the contract price and thereby defeat the legitimate interests of subcontractors. Subcontractors have an interest in the chose in action, the right of the contractor to payment of the contract price. There is nothing to stop the principal's financier "stepping in" as envisaged by Clayton Utz. The trust legislation does not have any effect upon the relationship between the principal and the principal's financiers.

(c) A contractor can settle claims with the principal. Except where a settlement is, to the knowledge of the principal, intended to avoid payment of subcontractors, the settlement would be quite binding. However, a collusive arrangement intended to defeat the interests of unpaid subcontractors could be set aside by the court. If a contractor is owed $1m by the principal and owes subcontractors $1.5 m, and the contractor agrees to accept $0.5m. in settlement of the claim upon the principal, the contractor is still liable to the subcontractors for $1.5m. The fact that the contractor compromises the claim upon the principal does not increase the overall liability of the contractor. The contractor is perfectly free to compromise the claim. It is not a fact, as claimed by Clayton Utz, that the proposed legislation defies commercial reality. With respect, what defies commercial reality is the misinterpretation which Clayton Utz put on the effect of the proposed legislation.

Where would be the alleged increased reliance upon litigation? Why would

contractors sue owners rather than compromise where they would now? There is no incentive for contractors to increasingly engage in litigation. Why would subcontractors sue contractors any more frequently than they do now? They are either owed money or they are not owed money. The trust legislation does not increase the debt.

Where there is no money to be recovered, subcontractors don't waste money suing. However, if on account of the trust legislation there are moneys available to subcontractors which otherwise would not have been available, they may sue where otherwise they would not have sued. The cause of the litigation would not be the trust legislation but the refusal of the defendant to recognise the liability created by the trust legislation, or the failure of the legal advisers of one party or the other to properly advise their client.

(c) There is no need for a provision for a contractor to retire as trustee. There is no such provision in the legislation of the many jurisdictions which have enacted trust legislation. A contractor cannot "retire" from the contractor's contractual obligations to a subcontractor. The contractual obligations and the trust obligations are co-extensive. One cannot exist without the other. They commence together and end together. There is no retiring from the trust obligations while the contractual obligations exist.

Clayton Utz refer to a situation where a contractor finances construction. In that event, the trust legislation would have no application to the contractor because the contractor would not be receiving money or be owed money for carrying out an improvement. The financier who exercises "step in" rights on default of the contractor would similarly not be affected by the trust legislation. There is nothing whatsoever to prevent the contractor from agreeing to the arrangement.

Paragraph 54

(a) This is covered in examples above. The contractor cannot draw margins while subcontractors remain unpaid. This is illustrated in *Horsman Bros. Holdings v Dahl* (1991) 125 DLR (3d) 405. If the contractor has so underpriced the work that progress payments don't include margins, or the principal has failed to pay the amounts due to the contractor, there will certainly be cost implications. However, in most contracts, the progress payments will cover the contractor's margins.

(b) The balance will be determined in accordance with the dispute resolution procedures applicable under the subcontract. Pending determination, the contractor will have to make the election referred to in example 3 under paragraph 42 above.

(c) Unless an amount is owed by the contractor to the subcontractor, the set off provisions have no application. You can only set off against an amount owed. Whether liquidated damages or damages for delay reduce the amount owed under a subcontract depends upon the interpretation of the subcontract. For example, in *Merritt Cairns Construction v Wulguru Heights* (1995) Build. CL 294 the Court of Appeal in Queensland held that liquidated damages for delay could not be deducted from progress payments. In a similar situation under a subcontract, the amounts received by the contractor from the principal would be subject to a trust until the contractor had paid the full amount of the progress payment without deduction of liquidated damages.

However, some contracts are so drafted that liquidated damages do reduce the amount owed. In such a contract, there would be no need to have recourse to section 16.

A right of set off against moneys owed and a right to retain moneys from the trust fund are not co-incidental. For example, assume that the subcontractor is owed $100,000 for work done under the contract. Assume that the subcontractor owes the contractor $60,000 in repayment of a loan quite unrelated to the contract. The contractor would naturally set one off against the other. However, $40,000 of the moneys received by the contractor from the principal would still be subject to the trust. Having been paid all moneys due, the subcontractor could not claim more. The fact that $40,000 is technically impressed with the trust is irrelevant. The contractor can use it for the contractor's own purposes. The subcontractor would have no cause of action because the subcontractor is no longer owed any moneys by the principal.

(d) As explained in response to paragraph 25, there is no duty to treat beneficiaries impartially. The alleged problem does not exist.

(e) The answer is no. See the response to paragraph 25 and, in particular, the Canadian Supreme Court decision referred to there.

(f) An injunction is always at the discretion of the court. There is no reason to

believe that courts need to be restricted in their powers to grant injunctions. An example of the court refusing an injunction in a construction trust situation is *Interel Environmental Technologies v United Jersey Bank* (1995) 894 F Supp 623. That New York case suggests that injunctions will not lightly be given.

(g) It means the former. If it meant the latter then it would be meaningless because, once "all persons for whose benefit the trust is constituted have been paid in full", the contractor is entitled to any balance. There would be no need for section 16.

Paragraphs 55 and 56 - No comment required.

Paragraph 57

With respect, Clayton Utz have it the wrong way around. The moneys held in trust are not assets of the contractor. The contractor does not owe fiduciary duties with respect to the contractor's assets. For example, if the contractor has received a progress payment of $100,000 and owes subcontractor's $80,000, then the contractor's own asset is $20,000.

Paragraph 58

There is no empirical evidence to show that financing arrangements will be affected. Ettinger, L.P in *Trusts in the Construction Industry*, Alberta Law Review Vol.27 390 at 395 reports that the Law Reform Commission of British Columbia stated that it had "discovered no evidence to suggest that the existence of a trust is increasing the difficulties of contractors and subcontractors in obtaining credit facilities from lending institutions" and the Manitoba Law Reform Commission "acknowledged that it had found no evidence of any impediment to financing and indeed found general favour for the trust scheme within the construction industry."

These two separate Law Reform Commission finding are also cited in the Canadian text referred to by Clayton Utz at paragraph 66. It is significant that Clayton Utz do not refer to them.

The Canadian Construction Industry does not share Clayton Utz' concern about the effect of the trust legislation on a contractor's ability to find finance. For example, in

a submission to the Newfoundland Law Reform Commission enquiry into whether construction trusts should be legislated for in that State, the Newfoundland and Labrador Construction Association "was extremely supportive" of trust legislation [Newfoundland Law Reform Commission Report NLRC-R3 1990 at p.86]. The Commission recommended the adoption of the trust legislation.

Paragraph 59

The allegation that assets to which employees would otherwise have recourse for payment upon an insolvency will be significantly reduced, is simply untrue. As it is, employees rank after secured creditors. Under the Amendments, payments in the construction chain will be available to pay employees before secured creditors.

Following the recent closure of the Cobar Mine, it is the secured creditors who will take all the income at the expense of the workers. Again, there has been a call for the creation of a trust scheme to protect workers. Had the Amendments been in force, the workers would have the priority over the financiers.

Paragraph 60

The Construction Payments Group's legal advisers considered the matter of possible conflict with other laws and are satisfied that there is no conflict. In particular, see the advice of R.V. Gyles QC of 22 April 1996.

Paragraphs 61 - No comment required.

Paragraph 62

The scheme presently proposed is a very modified version of the proposal referred to in the Green Paper. It is a different proposal. It also omits the "punitive regime" which was considered inappropriate in the Green Paper.

Paragraph 63

The scheme presently proposed was not considered. Neither the Western

Australian Government nor the Queensland Government rejected the scheme presently proposed. It has never been put to either Government.

Paragraph 64 to 66 - No comment required.

Paragraph 67

With respect, the authors of the text do not refer to "the need for any legislative provision to take proper account of the need for business efficacy". They say that "the legislation seeks to provide business efficacy". By copying that legislation, the Amendments similarly seek to provide business efficacy.

It should be noted that those learned Canadian Authors do not say that trust legislation gave rise "to extraordinary commercial consequences and additional complex legal issues". They do not suggest that the legislation does not work or that it is misconceived or adversely affects business efficacy.

The "many and detailed provisions enacted in some of the Canadian legislation" to which Clayton Utz refer are provisions dealing with liens not trusts. Invariably the trust provisions are brief and simple.

Clayton Utz ask, "What, if any, analysis has been made of the practical consequences of the Amendments?" Without the benefit of any analysis, Clayton Utz have come to the conclusion that the Amendments "would lead to extraordinary commercial consequences and additional complex legal issues" [p.ii].

The proponents of the Amendments have done their own analysis. They have come to the completely opposite view.

In Canada, The Law Reform Commission of British Columbia [1972], the Nova Scotia Law Reform Commission [1976], the Manitoba Law Reform Commission [1979], the Ontario Government's Advisory Committee [1982], the Saskatchewan Government's Advisory Committee on the Draft Construction Lien Act [1982], the Alberta Government/Industry Task Force on Builders' Liens [1988], and the Newfoundland Law Reform Commission [1990] and in the UK, the Latham Report on the UK Construction Industry all recommended the adoption of trusts. There

appear to be no similar enquiries which have recommended otherwise.

The Green paper on which Clayton Utz relies and the two "independent reports [Anderson Consulting and Price Waterhouse] do not fall into the same category. They did not involve the public submissions and thorough analysis of the Canadian and UK enquiries.

Paragraph 68

The very fact that Canadian states have one after the other adopted trust legislation, usually after a formal enquiry, is evidence that it does not "lead to extraordinary commercial consequences and additional complex legal issues" which Clayton Utz predict. The vast majority of construction contract work in Canada is carried out in states which have trust legislation. Trust legislation has not stopped construction in New York where it has existed for over half a century.

Anecdotal evidence from participants in the construction industries in Canada and the United States may be of interest but the fact that governments in so many jurisdictions have enacted the legislation speaks for itself. Until the Amendments are enacted and in operation, there will always be some who say that they will "lead to extraordinary commercial consequences and additional complex legal issues". The only way to actually prove the contrary is to enact the legislation and observe the consequences.

Paragraph 69

Sixty three pages in a text devoted to lien and trust legislation is not indicative of a fertile ground for litigation. On the contrary, in the 67 years that legislation has been around, it is surprising how few cases have arisen either in the US or Canada. With respect, the Amendments are not complex in a practical way or in a legal sense.

It must also be remembered that the Amendments do not attempt to go as far as the legislation which Clayton Utz is referring to. In particular,

the amendments do not attempt to make a principal a trustee or to make moneys advanced to the principal into trust moneys. It is that aspect of the trust legislation which has generated the majority of the litigation to which Clayton Utz refer.

Paragraphs 70 and 71 - No further comment required.

Paragraphs 72 and 73

The provisions of section 16 would not defeat the contractual right of a party to apply retention or security for the purposes covered in the contract.

Clayton Utz ask how can the contractor access money which the contractor retains from trust moneys. The answer is simple. The contractor simply withdraws the money from the trust moneys. If they are not in a separate bank account the withdrawal is a book entry. If they are in a separate bank account, the contractor simply draws a cheque on the account.

Paragraph 74 - No comment required.

Paragraph 75

The right of suspension of work is an important protection. The need was recognised in the Latham Report into the UK construction industry and the right was enshrined in section 109 of the Housing Grants, Construction and Regeneration Act 1996 [UK].

The contractor is not required to put into the separate trust account any additional moneys. All that is required is a transfer from one trust account to another - a book entry. The contractor is not required to deposit any of the contractor's own moneys in the separate account. The separate trust account is only to ensure that the moneys which the contractor already holds in trust are not paid to another subcontractor. By separating an amount out of the general trust funds, a specifically identifiable portion of the overall trust moneys is held in trust for the particular subcontractor. The contractor is not required to deposit into the separate account any more than the actual debt which the contractor owes but refuses to pay the subcontractor. The same rights of set off exist with respect to the separate account as would exist if the moneys were in the general trust account.

Clayton Utz ask, "when will the trust come to an end?" It will come to an end when the contractor pays the debt which is secured by the trust. If there is no debt, there is no trust. If there was no debt in the first place, the contractor had no obligation to hold moneys in trust.

Clayton Utz does raise a legitimate point, section 18 does not specifically limit the right of suspension of work to suspension of work on the particular project. This will be addressed.

Paragraphs 76 to 81 - Clayton Utz are referring to section 17 in the Amendments. Without the information which section 17 requires the defaulting contractor to provide to the unpaid subcontractor, the unpaid subcontractor would not be able to trace misappropriated trust moneys. If a contractor is unable to pay debts, there is no reason why the contractor should be able to conceal records and thereby prevent or hinder a creditor from enforcing remedies against the contractor's directors or others who hold or have misappropriated trust moneys.

Paragraph 82

With respect, Clayton Utz misrepresent the effect of section 17. It is not sufficient that the subcontractor believes that the subcontractor is owed money. The subcontractor must actually be owed money for work done or materials supplied.

Paragraph 83

As mentioned in response to paragraph 2 of the Executive Summary, these are not assertions of the authors. The matter is dealt with in detail in that response.

Paragraph 84

A separate fund can be created without a separate bank account. It is a bookkeeping exercise.

Paragraph 85

This is the opinion of Clayton Utz. It is not the opinion of other lawyers.

Paragraphs 86 and 87 - See paragraph 83.

Paragraph 88

These assertions are contradicted by evidence from other jurisdictions which have enacted construction trust legislation.

Clayton Utz have asked a lot of questions. These questions have been answered. The legislation is not nearly as difficult to understand as Clayton Utz appear to find it. It is simple legislation. There is no need to make it "exceptionally detailed". It works well elsewhere. There is absolutely no reason to believe that it will not work equally well in Australia.

Document 6

Philip Davenport on behalf of the Construction Payment Group

Response to Coopers & Lybrand Report of August 1996

CONSTRUCTION PAYMENT GROUP

RESPONSE FEBRUARY, 1998

COOPERS LYBRAND

The report dated August 1996, was only released in February 1998. Like the other reports prepared by consulting firms they have failed in the analysis of the fundamental purpose of the proposals then submitted.

The detailed response follows.

Response of the Construction Payments group to Coopers & Lybrand Report of August 1996

1. Introduction

The Coopers & Lybrand Report can be summed up in four words, "Its all too difficult". The word "difficult" occurs time and time again. The degree of difficulty of anything depends upon how well the commentator understands it. With respect, the trust concept is simplicity itself. Coopers & Lybrand even say it is "too simplistic" [p.24]. It is time that the debate moved from adjectives to actual examples.

The Coopers and Lybrand Report does not deal with the proposed amendments to the Contractors Debts Bill relating to statutory trusts. It deals with a much more ambitious proposal which, in the interests of compromise, has been considerably modified in the proposed amendments.

The proposed amendments address all the legal and practical difficulties identified by Coopers & Lybrand and by Mr. Davenport in the review cited by Coopers & Lybrand. In that review, Mr. Davenport recommended a trust model which he said avoided the difficulties and would work. That is precisely the trust model which has now been incorporated in the proposed amendments to the Contractors Debts Bill.

With respect, Coopers & Lybrand have approached the topic from the wrong angle. At p.20 Coopers & Lybrand say:

> The viability of this proposal must be considered in light of the benefit to the industry participants that this initiative will give as against the cost.

The purpose of the proposal is not to benefit the industry as a whole. That may ultimately be a by-product of the legislation but the purpose is to provide greater protection for workers, subcontractors and suppliers.

Taking the "total industry" approach, Coopers & Lybrand conclude that the losses being sustained by claimants "are not considered significant in the context of the total industry activity". That is small consolation to those who do sustain a loss, particularly when they know that had they been contracting in the United States or Canada there would have been legislation which might have enabled them to avoid or minimise the loss.

Coopers & Lybrand give no consideration to why things should be different in Australia. They don't attempt to explain why trusts are too difficult to implement in Australia but not in the United States or Canada. With respect, they have not researched to subject. They refer to "legal difficulties" and list three. These are dealt with below. They blame losses on "lack of adequate capital, financial management, poor job costing and external factors" without giving consideration to the very reason for the trust proposal, namely that it is the legal system itself which needs adjustment. It is on account of an imbalance in the rights accorded by law that results in losses falling upon workers, subcontractors and suppliers rather than upon those who should be bearing them.

This legal imbalance has been recognised in every State in the United States and Canada, in the United Kingdom, New Zealand, South Australia and Queensland and probably countless other countries. The Security of Payments Committee and others, including Mr. Davenport who features so prominently in the Coopers & Lybrand Report, have examined the legislation in other jurisdictions and the reports of various Law Reform Commissions and others and have concluded that trusts would provide the most simple method of redressing the legal imbalance.

However, Coopers & Lybrand do not see the problem in terms of a legal imbalance but in "total industry terms". They suggest "policing existing legal sanctions" [p.2] and say "The existing legal system does have in it a number of incentives for operators in the industry and in commerce generally to act in a proper and fair manner." They miss the point that even if a contractor acts in a proper and fair manner, the contractor must work within the existing legal regime and it is that regime which fails to give a subcontractor any lien in respect of work done. No matter how much the contractor would like to see workers, subcontractors and suppliers paid before the contractor's financier, the contractor is powerless to prevent the contractor's financier from taking the fruits of the work of the subcontractors and leaving subcontractors to bear the loss.

Coopers & Lybrand say that the trust proposal is not viable because "the proposal will not ensure that all subcontractors and suppliers will get paid" [p.4]. Of course the proposal will not achieve that. It was never suggested that it would.

Contradictions

There are a number of contradictions in Coopers & Lybrand Report. On the one hand they say at p.26, "the concept of a deemed trust is theoretically sound and simple to implement" and at p.27, "should be carefully considered and implemented largely through imposing the appropriate conditions in standard contracts" and that "This initiative would in itself lessen the likelihood of funds being misused and misdirected" and "contribute to creating an environment where those participants who may be experiencing financial difficulties could be identified on a more timely basis to enable appropriate action to be taken to avoid or minimise the losses suffered" and on the other hand Coopers & Lybrand say at p.5 that the deemed trust proposal is not viable because it is at odds with commercial reality and the existing legal system is adequate.

While suggesting that the existing legal system is adequate [p.5] they recommend [p.4] that "existing legislation such as the Bankruptcy Act, Corporations law and Oaths Act be reviewed" [see also p.30]. But one of the problems which they saw with the SOPC proposal was the need to amend Federal legislation.

While concurring with Mr. Davenport's view on the former proposal, Coopers & Lybrand make no comment on Mr. Davenport's "Outline Draft for a Construction Industry Trust Act" which was an appendix to the review cited by Coopers & Lybrand and which is the basis of the proposed amendments to the Contractors Debts Bill. They have not considered to viability of that proposal.

The Coopers & Lybrand report is not based upon their own research. It is based upon a review of:

SOPC proposal

Anderson Consulting Report

SOPC response to that report

Mr. Davenport's review

Mr. Gyles QC's advice

interviews with some unnamed people and a one day workshop with Deacon Graham & James [see p.10]. With respect, this is a most superficial approach.

What is evidence to support their conclusions? Coopers & Lybrand apparently made no effort to examine overseas experience, overseas legislation or published literature on the subject. With respect, such an important issue as trusts in the construction industry should not be influenced by such a superficial review.

2 Legal Difficulties [p.5]

Coopers & Lybrand [at p.5] say that the legal difficulties are in three main areas. The first is "the requirement for Federal Legislation". In the review cited by Coopers & Lybrand, Mr. Davenport identified that as a difficulty with the earlier proposal. He included in his review a model for State legislation which would not involve changing any Federal legislation or any "Trustee Acts". That model has been adopted as the proposed amendment to the Contractors Debts Bill.

The second main area of difficulty identified by Coopers & Lybrand [p.5] is that "trusts may be difficult to implement due to the complex relationships being created". Mr. Davenport also identified that as a problem in his review. He proposed a much simpler model. That is the model now adopted.

The third main area of difficulty identified by Coopers & Lybrand [p.5] is that "commercial uncertainty is created by imposing trust law over contract law, which will lead to significant potential for increased levels of disputation." Granted, there was some uncertainty in the earlier proposal. It was not in the form of draft legislation. However, the present modified proposal removes that uncertainty.

Allegations that trusts will lead to "increased levels of disputation" are frequently made but there is no empirical evidence to back the allegations. Trust legislation of the type proposed has been in existence in the United States and Canada for over 65 years. Michigan introduced it in 1931, Manitoba in 1932, New York and Ontario in 1942. It exists in British Columbia, New Brunswick, Saskatchewan, Alberta, Maryland, Wisconsin, Oklahoma and Texas. It probably exists is many more States. Trusts have been in NSW Department of Public Works and Services and Defence

Department standard form construction management contracts for many years without any evidence of "increased levels of disputation".

Perusal of texts such as McKinney's Consolidated Laws of New York [Book 32, Lien law] and Macklem and Bristows' Construction and Mechanics' Liens in Canada will show that in over 65 years there has been very little litigation over construction trusts.

The trust legislation will not increase the number of disputes between subcontractors and contractors or between contractors and owners. Money is either owed or not under a contract or subcontract. The existence of the trust will not affect that issue. The trust legislation in no affects the contractual liability of one party to the other in the contractual chain.

The trust legislation opens to door to claims by an unpaid subcontractor against third parties who are withholding or have wrongfully misappropriated moneys which properly belong to the subcontractor. For example, assume that the principal pays the contractor $150,000 on a project and workers and subcontractors are owed $100,000 for work or materials. Assume that a bank, a receiver or liquidator seizes the whole $150,000. Then the workers and subcontractors could sue the bank, the receiver or liquidator for the $100,000 which is properly theirs.

It is this type of dispute which may be thrown up by the legislation. If the bank, receiver or liquidator obtains proper legal advice, the dispute should be resolved quickly. An increase in disputation, if any, will not be caused by the trust legislation but by people failing to comply with it.

Page 5

Coopers & Lybrand say that the SOPC proposal is not viable due to five points. Lets take these one at a time.

The proposal is at odds with the commercial reality of the industry

With respect, that is meaningless. What is "the commercial reality"? Precisely what is the conflict between what aspect of the proposal and what aspect of "the commercial reality"? Construction trusts exist in New York and Toronto. Is commercial reality in Sydney different?

Significant legal difficulties

For the "legal difficulties" Coopers & Lybrand place much emphasis on a review given by Mr. Davenport to the Department of Public Works and Services but Coopers & Lybrand fail to mention that Mr. Davenport was most supportive of trusts. He identified significant legal difficulties in the 1992 SOPC proposal and recommended changes which would overcome those difficulties and even included a draft bill in his review. The synopsis to his review read:

> The proposal for a series of trusts is an excellent idea. Construction industry

> trusts have existed in Canada for some time and are presently being considered in the United Kingdom. However, the proposal goes much further than mere trusts. For that reason it will not succeed in its present form. The proposal includes making owners liable directly to subcontractors and suppliers, giving unpaid subcontractors and suppliers preference over unpaid workers and changing all construction contracts. Implementation of the proposal would require Federal legislation. A modified proposal limited to trusts for workers, subcontractors and suppliers may succeed. A recommended draft is in the Appendix.

With respect, Coopers & Lybrand give a quite false impression of Mr. Davenport's views on the viability of construction trusts.

The existing legal system can already provide a range of remedies and sanctions for unethical behaviour

The trust is not intended as a remedy for unethical behaviour.

Coopers & Lybrand say, "At best [the proposal] will provide as a consequence of penalties a strong incentive for people to meet their obligations" [p.4]. The point which Coopers & Lybrand misses is that the proposals are about changing rights not enforcing obligations. They are about title to moneys not enforcing existing obligations. The obligations created by the trust proposals are only incidental to the ownership of the moneys. The proposals do not affect the obligations of people in the contractual chain to pay their debts. At present A can quite lawfully use the fruits B's labour to pay C. Under the proposal A can only use the fruits of B's labour to pay B. The fruits of B's labour will never become the property of A. This point appears to have escaped Coopers & Lybrand.

Industry specific legislation creating difficulties in the recovery process, adding to the costs of recovery and time

With respect, this does not make sense. Who is recovering from whom? Whose costs will be increased? Why will "time" be "added to"?

Complexity and cost the deemed trust will bring to the industry

Coopers & Lybrand give one example at p.24. That example is analysed below in terms of the presently proposed trust legislation. It will be seen that there is no complexity involved and no additional cost.

Page 21

Coopers & Lybrand list six matters which they say that proposed legislation would need to address. They are as follows:

1. What is trust money.

That is spelt out in the draft legislation. It is retention moneys, cash security,

moneys received and to be received by the contractor for carrying out the improvement.

2. Which party in the supply chain is entitled to the trust money?

It is the party who put up the security or against whom retention is held and subcontractors and others who have provided work, materials or services for the improvement. When there is more than one claimant and the contractor is insolvent, the claimants share ratably. If the contractor is solvent, the contractor is free to distribute the progress payments in payment of any beneficiary.

3. The precise point in time when the trust crystalises.

It is the time when the contractor receives trust moneys. There will be various times. The time of lodgement of a claim by a beneficiary is irrelevant. Priority does not arise from the time of lodgment of a claim.

4. A third party claims moneys held in trust

The contractor cannot pay trust moneys to a third party. If the contractor has a single bank account and it contains both moneys held in trust and moneys which belong to the contractor, a third party can claim [garnishee] that part of the moneys which are the contractors but not the trust moneys.

5. Does the principle of acting in good faith apply?

The contractor cannot use trust funds for any purpose other than to pay beneficiaries. If the contractor uses the funds on project A to pay amounts due to a "critical contractor" on project A, then no other beneficiary can have cause of complaint. But the contractor cannot use funds from project A to pay a subcontractor on project B while subcontractors on project A remain unpaid.

6. Uncertainty may be caused by the application of the law of trusts to the law of contract.

There is no such uncertainty. Trusts for retention moneys and security are common in construction contracts. Other trusts are not uncommon in construction contracts. There can be no conflict between the contractors commercial interests and the contractors duty to trust beneficiaries.

Page 24

Note the sweeping observation in the fourth paragraph, namely that "solutions generally are not successful if they are based on a legislative initiative to impose upon all participants the manner in which they are to transact business between them". Given that philosophy, we would have no laws whatsoever to regulate business.

Taking the example at the foot of the page and the draft trust legislation, the situation would be as follows:

1. The head contractor would need separate accounts for each project. This does not mean that the contractor must have four separate bank accounts. It means that the income and expenditure on each project would have to be separately identified in the contractor's accounting records. Most, if not all contractors would already be doing that.

2. If a subcontractor was working on more than one project, the subcontractor would similarly have to keep separate records of receipts and payments on each project.

3. The contractor would have to ensure that a payment received from the principal on project no.1 is used first to pay workers, subcontractors and suppliers who have provided labour, materials or services for project no.1. Once those people have been paid, the contractor is free to use the balance for any purpose.

4. Coopers & Lybrand say that as the law presently stands, when the contractor is placed in liquidation the $1m funds would be paid to employees of the contractor first, then secured and unsecured creditors. With respect, that is not how it works. Almost invariably, a financier appoints a receiver who take the whole $1m. leaving nothing for workers, subcontractors or suppliers. The recent Cobar Mine insolvency is a typical example.

5. Under the trust proposal, when the contractor is placed in liquidation, the final payment due from the principal on project no.1 would have to be first applied to payment of unpaid workers, subcontractor and suppliers on project no.1. They would share ratably. Any balance left over would probably go to a receiver for the bank which had financed the contractor.

6. Similarly, money received from the principal on project no.2 would be applied first to payment of workers, subcontractors and suppliers on project no.2. This would not be a difficult accounting exercise.

7. If the contractor has failed to keep proper records, it may be difficult to decide in respect of which project what portion, if any, of moneys in a single bank account came from which principal.

8. Coopers & Lybrand ask, "Are all subcontractors and non contract creditors entitled to monies if plant and equipment is purchased by the trust?" The "trust" can't purchase anything. Trust funds can't lawfully be used to purchase anything. They can only lawfully be used to pay workers, subcontractors or suppliers. The trustee [the contractor] might misappropriate trust funds. In that event the contractor's director or manager who actually takes the trust money could have a personal liability. It might be possible for the unpaid workers, subcontractors or suppliers to make a proprietary claim in respect of the plant and equipment purchased with their money.

9. Coopers & Lybrand ask, "Will the 100 suppliers be able to claim against the contractor?" The answer is, "No". The reason is that on the facts as postulated, they have not contracted with the contractor but only with subcontractors.

10. In so far as concerns the three final payments to be made by the principals on the three completed projects, there will be no "tracing exercise" whatsoever. The moneys received from the principal will be three separate trust funds for the benefit of the workers, subcontractors and suppliers on the respective projects. Subcontractors on project no.1 will have no call on the money received in respect of project no.2.

11. There will be no tracing exercise with respect to the 100 suppliers. There may be a tracing exercise with respect to the 20 unpaid subcontractors who still remain unpaid. How difficult the exercise will be will depend upon how good the contractor's records are. How far the subcontractors will take the tracing will depend upon how much they are likely to recoup and how much they are prepared to spend on tracing. Whether there will be litigation will depend to a large extent on how much money is at stake.

12. It cannot be said that there will be any significant increase in litigation. It will only be in the event of the winding up of a major contractor with significant assets that litigation will be worthwhile.

13. A liquidator may have more work to do in sorting out who is entitled to what. For that reason, sometimes it may take longer to finalise a winding up. On the other hand, sometimes it will be easier and faster. That would occur when the only significant assets are payments from principals. Those payments will usually go straight to workers, subcontractors and suppliers of the contractor.

14. Coopers & Lybrand says that the benefit of the trust could be lost in meeting the cost of sorting out the many potential issues on winding up. This will sometimes happen but in a significantly large number of cases there is a final payment due from the principal after the contractor becomes insolvent. The distribution of that would not be difficult and could make a real difference to the unpaid workers, subcontractors and suppliers.

Conclusion

The Coopers & Lybrand Report comprises opinions (often contradictory) which are not based upon actual experience or research. The Report does not address the legislation actually proposed. The report is fatally flawed an is of no assistance in this debate.

Document 7

Australian Bankers' Association

Correspondence: 3 March 1998; 6 March 1998

AUSTRALIAN BANKERS' ASSOCIATION

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6 March 1998

Mr George Cepak
Director
Joint Standing Committee Upon Small Business
Parliament House
Macquarie Street
SYDNEY NSW 2000 **Fax No 02 9230 3052**

Dear Mr Cepak

Further to my letter of 3 March 1998 I have had an opportunity to review in detail the material which you sent to me on 27 February 1998. and in particular, the response provided by Mr Davenport on behalf of the Construction Payments Group to both the Coopers and Lybrand report of August 1996 and the analysis of the proposed amendments by Clayton Utz.

There is nothing in what Mr Davenport has written which would change our view of the proposed legislation as expressed in our letter to you of 3 March 1998 or, indeed, our letter of 11 May 1992. I would like to make a couple of important points clear.

The Joint Committee is working to find an acceptable solution to a problem. There is a significant section of the construction industry opposed to the trusts proposal. Industry based solutions, some of which have already been put forward, should be given greater consideration instead of pursuing a "solution" which is becoming "bogged" down in an exchange of legal niceties. It is quite clear that the points of difference between the proponents and the opponents of the trust proposal are so great that any early compromise would seem to be beyond reach.

Turning to Mr Davenport's responses, in his response to the Coopers and Lybrand report (page 4) he refers to an example of a bank being accountable for $150,000.00. It is not correct to say that by the bank taking legal advice, a dispute over the entitlement to the monies will be resolved quickly. If, for example, a head contractor transferred monies from a sub-contractors' payments trust account to reduce the balance of the head contractor's overdraft with the bank, it would not automatically follow that the bank would be liable.

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Factors such as the knowledge of the bank, its conduct and whether the transfer was made pursuant to any insistence on the part of the bank would all be relevant considerations. The knowledge of the bank in relation to the circumstances of the transfer would include not only the actual knowledge of the bank but what a Court would consider a bank acting reasonably ought to have known if it had made enquiries. Mr Davenport would know that legal disputes over what is known as constructive knowledge are frequent and complex.

In an unreported Canadian decision in the High Court of Ontario (Arthur Anderson Inc v. Toronto-Dominion Bank 16 July 1992), a bank was held liable for applying monies impressed with a statutory trust in favour of sub-contractors to a construction company in reduction of overdraft accounts of the company and related companies. The bank was presumed to know the law and ought to have known, consequently, that its actions were in breach of trust.

Cases such as the Arthur Anderson case demonstrate the onerous burdens placed upon banks in matters concerning trusts and their potential liability to themselves becoming constructive trustees and accountable, even though they have acted in absolute good faith.

On pages 6 and 7 of Mr Davenport's response to the Coopers and Lybrand report he makes reference to there being no need for separate trust accounts or even separate accounts keeping the head contractors monies separate from the trust monies. What if the head contractor operates a single account with the bank to which is attached an overdraft facility? Monies credited to the account constitute repayments to the bank when the account is overdrawn. If the account contains a mixture of trust monies and the head contractor's own monies, how does a bank determine in any particular circumstance which money it is entitled to and to which it is not? The obvious answer is that separate accounts have to be conducted. Prudent banking practice dictates that no overdraft facility should be permitted on a trust account unless the trust instrument or legislation gives clear power and authority for that borrowing and the overdraft is clearly for the purposes or benefit of the trust.

Also, it is a fundamental principle of trust law that a trustee must keep trust monies separate from the trustee's own personal monies. Also the trustee must not mix and blend the trust monies of multiple trusts.

Mr Davenport asserts that the trust legislation will mean that the rights and liabilities of parties will be clear and that this will produce a reduction in litigation. In practice, the application of trust law has featured in a large number of commercial cases in the Courts and, in particular, cases involving banks.

Mr Davenport's response to the Clayton Utz material makes similar assertions about the ability for the head contractor to conduct one bank account. For the reasons already stated, this is not possible in any practical or legal sense where trust law applies.

If payments received by a head contractor are impressed with a trust, not only will those monies not be available to service the normal working capital requirements of the head contractor, ie cash flow requirements, but also the head contractor would be unable to derive any personal benefit from having those funds standing to the credit of the account. For

AUSTRALIAN BANKERS ASSOCIATION

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3 March 1998

Mr George Cepak
Director
Joint Standing Committee Upon Small Business
Parliament House
Macquarie Street
SYDNEY NSW 2000 **Fax No 02 9230 3052**

Dear Mr Cepak

Since the last working party meeting held on Wednesday 28 January 1998 a lot has been written about the security of payments issue. At the last meeting I agreed to provide a copy of a letter sent to the Chairman of the New South Wales Security of Payment Committee on 11 May 1992. A copy of that letter is attached.

According to our records I have been able to ascertain that some discussions were subsequently undertaken with the Committee in an endeavour to resolve ABA's concerns.

However, the proposal for legislation circulated on 13 January 1998 does not appear to address the concerns that ABA raised in its letter of 11 May 1992.

We believe that the introduction of the trust concept into the ordinary debtor and creditor contractual relationship is likely to create a number of unintended consequences which would have a high degree of legal complexity.

As currently drafted, the proposed amendment to the Contractors' Debts Bill

- would import the complex law of trusts into the contractual relationship between a contractor and a sub-contractor.

- would have the effect of preferring sub-contractors over other creditors in the event of an insolvency.

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- through undue reliance on the trust, would encourage lax collection and debtor control practices to develop (for example, this was evident before the repeal of Section 221P of the Income Tax Assessment Act under which the Deputy Commissioner of Taxation had a priority over ordinary creditors when an insolvency administrator was appointed to a company).

- would necessitate separate accounting and separate trust accounts to be established by banks.

- would impose restrictions on the cashflow of contractors and as a consequence would affect contractors' access to finance and interest rate margins.

- would prevent a financier from taking security over a significant portion of a contractor's cashflow (ie the contractor's assets represented by the contractor's debtors).

- would place unacceptable burdens on banks and other deposit taking institutions to supervise the trust arrangements to ensure that no breach of trust ensued (this is a consequential effect of the application of trust laws ie the bank or other deposit taker could become the constructive trustee of monies for the sub-contractor).

A possible misconception underpinning the trust proposal is that it is the owner's monies which are the only monies to flow through a particular development. However this assumption ignores the nature of cashflow and supplementary working capital funding for contractors down the line to support their business undertakings. If neither the contractor nor the financier is able to have access to the cash flows for day to day working capital requirements, as the trust proposal would imply, this would jeopardise the viability of contractors' businesses.

Banks would not support a solution to the current problem which involves exposing banks to a new and potentially onerous liability.

If the industry could devise a set of standards or a self-regulatory code governing collection and payment practices and provide for contractors to receive accreditation through adoption of the practices or code many of the difficulties sought to be resolved by legislation could be avoided. The Practice Note which the Property Council of Australia has provided together with likely changes to the terms of contract clauses are examples of how the industry could approach self regulation.

Yours sincerely

Ian Gilbert
Director

example, an interest off-set arrangement involving the trust account and the personal borrowings of the head contractor could not be entertained by a bank. This is a clear financial implication for the head contractor of the trust arrangements. In other words, the flexibility of a bank in providing financing arrangements for the head contractor will be limited by reason of the existence of the statutory trust.

As evidence of the complexity of the application of trust law to a banking relationship, the authors of "The Law Relating to Banking and Customer in Australia" (Weaver and Craigie) Volume 1 devote some 32 pages of legal analysis to these implications. It is evident that the application of trust law to a banking relationship is complex, fraught with uncertainty and conducive to litigation.

Although we support the Joint Committee in seeking to find a solution to the plight of unpaid sub-contractors, ABA cannot support a solution based upon the trust proposal as set out in the draft legislation.

Yours sincerely

Ian Gilbert
Director

Document 8

Philip Davenport on behalf of the Construction Payment Group

Response to letter of the Australian Bankers' Association dated 3rd March

Philip Davenport
Solicitor & Barrister

10 March, 1998

Mr George Cepak
Director
Joint Standing Committee upon Small Business
Parliament House
Macquarie Street
SYDNEY NSW 2000

Dear Mr Cepak,

Contractors Debts Bill

I write on behalf of the Construction Payment Group and refer to a letter dated 3rd March from Mr Gilbert, Director of the Australian Bankers' Association.

Mr. Gilbert says that the trust concept is likely to have a number of unintended consequences. He lists seven alleged consequences. Indeed, the trust proposal would have some of those consequences - that is its very purpose. The consequences which it will have are not unintended. They are very definitely intended to redress the imbalance which now exists in the construction industry. However, the trust proposal will not have some of the consequences forecast by Mr. Gilbert.

Dealing seriatim with Mr. Gilbert's seven objections:

1. The proposed legislation will import the law of trusts into the contractual relationship between a contractor and subcontractor. The adjective "complex" used by Mr. Gilbert is misleading. There is nothing particularly complex about the proposed trust legislation.

2. In so far as concerns money received for work done on a project, in the event of an insolvency, the legislation will have the effect of preferring workers, subcontractors and suppliers on that project over other creditors who have not contributed to the earning of the money. The proposed legislation would not otherwise affect the order of priority in an insolvency.

3. There is absolutely nothing whatsoever to suggest that the proposed legislation will "encourage lax collection and debtor control practices". On the contrary, the legislation should encourage better accounting practices.

4. Separate accounting will be necessary. This is only good accounting practice. It is what any efficient contractor would already be doing. Except for retention moneys and cash security [which should already be held in separate trust

accounts], whether a contractor opens a separate trust account is a matter for the contractor. The contractor's bank may want the contractor to open a separate trust account so that the bank knows which moneys the bank can seize and which moneys are not, in fact, the contractor's. Banks seem to have no difficulty now coping with separate trust accounts for security and retention moneys.

5. The proposed legislation will not impose restrictions on the cash flow of contractors. They will still receive exactly the same cash flow as now exists. The proposed legislation might "affect contractors' access to finance" in one situation. That is where a contractor has been using the subcontractor's money as the contractor's in order to obtain finance. This is the very practice which the proposed legislation is aimed at stopping.

6. The proposed legislation would prevent a financier from taking security over a significant portion of a contractor's cashflow, namely that portion which, in truth, belongs to the workers, subcontractors and suppliers who by their work, services or materials earned that portion of the cashflow. The financier would not be able to take Peter's money to meet Paul's debt to the financier. There is absolutely nothing wrong with that. A bank cannot take the money of a client of a solicitor to discharge the solicitor's debt to the bank. Similarly, under the proposed legislation, the bank cannot use the subcontractor's money to discharge the contractor's debt to the bank. The consequence should be that in future banks will be careful when lending money to a contractor to ensure that the contractor will be able to meet the liability otherwise than by using moneys belonging to workers, subcontractors or suppliers.

7. The proposed legislation would not place any burden whatsoever on banks and other deposit taking institutions "to supervise the trust arrangements to ensure that no breach of trust ensued". The proposed legislation imposes no "policing role" whatsoever on banks. Banks hold and have held trust moneys since time immemorial. No bank would refuse to accept a deposit of trust moneys because of the alleged "unacceptable burden". Banks in the United States and Canada have no problem with accepting deposits from contractors and doing their banking. Where a problem arises is when a bank refuses to allow the withdrawal of trust moneys because the bank claims the moneys as its own. When the bank acts unlawfully, a court may hold that the bank is a constructive trustee.

In the third last paragraph of his letter, Mr. Gilbert says, "If neither the contractor nor the financier is able to have access to the cash flows for day to day working capital requirements ... this would jeopardise the viability of contractors' business". In so far as the "working capital requirements" are the purchase of labour, materials or services for a project, the contractor, and through the contractor, the financier, has access to the total cash flow on that project. However, under the proposed legislation, the contractor and the financier would not have access to the cashflow on project A to finance project B or C or for any other purpose until the workers, subcontractors and suppliers on project A have been paid what is due to them. If a

contractor cannot finance project B without "borrowing" or "stealing" moneys from the subcontractors on project A, then the proposed legislation will indeed "jeopardise the viability of the contractor's business". The contractor should not be taking on more work than the contractor can properly finance.

In his penultimate paragraph Mr. Gilbert says, "Banks would not support a solution to the current problem which involves exposing banks to a new and potentially onerous liability". The proposed legislation imposes absolutely no new or potentially onerous liability on banks. For banks, the only effect of the proposed legislation will simply be that they will not be able to use a subcontractor's moneys to discharge the contractor's debt to the bank.

For a bank's own protection when doing a credit check on a contractor who is a customer or a potential customer, the bank could no longer treat the whole contract price as an asset of the contractor available to meet the contractor's liability to the bank. The whole contract price could not be the subject of a charge to the bank. However, when a bank does a credit check on anyone, the bank must distinguish assets which the person holds in their own right and assets which are held on trust. There is no additional burden placed on banks.

In the final paragraph Mr. Gilbert says that by means of a "self-regulatory code governing collection and payment practice ... many of the difficulties sought to be resolved by legislation could be avoided". Perhaps it is the banks which should be considering a "self regulatory code". If banks did not lend to contractors on the security of moneys which properly belong to others, the present problem would not be so acute. When a contractor become insolvent, it is almost invariably the contractor's bank which takes such assets as exist, leaving nothing to pay subcontractors.

It is unfortunate that the Australian Banking Association has not made any constructive suggestions. The Association has apparently not enquired of its United States or Canadian colleagues as to how they deal with the trust legislation which exists in those jurisdictions. The association has not considered the possibility of an amendment which would allow banks to have the same rights as subcontractors [the same trust protection] in respect of moneys advanced for and paid to workers, subcontractors or suppliers on a project.

For example, if a bank advances $100,000 to a contractor to pay workers, subcontractors or suppliers on project A, and the contractor actually uses that advance for that purpose, should amounts paid or owed by the principal on project A be received or receivable by the contractor on trust for repayment to the bank of the $100,000. After all, if the $100,000 is actually used to pay the workers, subcontractors or suppliers, there is a good argument that the bank has itself provided services to enable the construction of project A and, in an insolvency, those who have received the $100,000 should not be preferred to the bank which has paid the $100,000.

Rather than simply opposing the legislation, the Association might consider whether, if the legislation is to proceed, amendments would be required to provide legitimate protection for the banks. In the letter of 11 May 1992, referring to an earlier proposal, the Association mentions "some form of protection to banks so that they will not be liable as constructive trustees provided that they act in the normal course of banking business". With respect, this is too vague. As mentioned before, the liability as constructive trustee arises when the bank seizes Peter's money to pay Paul's debt to the bank. However, there may be some amendment which could make special provision for banks or financiers without detracting from the rights of subcontractors and others.

Perhaps the Association should be asked again to consider precisely what, if any, amendments to the present draft, the Association would recommend if the trust legislation is to go forward.

Yours sincerely,

pp. Philip Davenport.

Document 9

Australian Finance Conference

Correspondence: 5 March 1998

Australian Finance Conference Level 22, 68 Pitt Street, Sydney, 2000. G.P.O. Box 1595 Sydney, 2001
Telephone: (02) 9231 5877 Facsimile: (02) 9232 5647

5 March 1998

The Hon Edward Obeid, MLC
Chairperson
Joint Parliamentary Committee Upon Small Business
Parliament House
Macquarie Street
SYDNEY NSW 2000

Facsimile: 9230 3052 [3 pages]

Dear Mr Obeid,

Security of Payment in the Construction Industry

Thank you for giving us the opportunity to comment on the debate so far and the proposals for reform of the system of payment for goods and services in the construction industry. Our comments take into account material sent to us to date by your Committee. We have elected not to engage in the detail of the debate, rather to drawn attention to our perspective.

The Australian Finance Conference (AFC) is the national finance industry association. A list of our members is attached. A number of our members provide finance to the construction industry, in particular small to medium sized building contractors and developers. Builders often rely on the cash flow generated from the receipt of progress payments to operate their businesses. This is recognised by financiers who factor this into the credit risk assessment and often prudently take security over the builder's cash flow. We believe, any framework for reform of the building industry payments system needs to take into account its impact on the credit risk assessment process and the availability of finance to the construction industry.

AFC supports the development of a scheme which provides greater assurance to all parties in the payment chain, that they will be paid for goods and services provided, in a timely manner. In particular, we acknowledge the need to protect sub-contractors and, indeed, some members adopt the policy of paying sub-contractors directly at the direction of the head contractor.

At times during the Joint Committee hearings to date, it has been mentioned by others that AFC supports the proposal for the introduction of a legislative scheme of deemed trusts. We would like to make it clear that we have intentionally not expressed any opinion as to the appropriateness of that or any other scheme at this stage; preferring to make an assessment after all options have been fully explored.

However, at this stage the deemed trust scheme, involving amendment of the *Contractors Debts Act 1997*, appears to be the only solution proposed of substance. Some other market based solutions have been suggested (most of which operate to some extent now) and include the adoption of principles of best practice, industry codes of conduct and the use of security of payment protection insurances. We consider each of these market based solutions may have merit (certainly, from our observations, they seem to have less of an effect on the credit risk assessment process, compared to the deemed trust proposal). However, it is difficult for us to comment on whether these market based solutions individually, collectively or in tandem with other options can produce an overall acceptable solution without a comprehensive proposal having been presented at this stage.

We consider it appropriate at this stage to make clear, from the financier's perspective, the potential consequences of the deemed trust scheme put forward. They are:

1) the requirement to hold income on trust to pay subcontractors and others will have negative implications for the builders cash flow, ability to service debt and ultimately may impact on the viability of the builder's business;

2) the trust will interfere with payment priorities in the case of insolvency of the builder;

3) as a consequence of (1) and (2) there may be implications for the availability of finance and/or the price of finance to the industry;

4) the description of beneficiaries under the trust is very broad and could accommodate a range of competing interests including a financier (as a service provider), a result we assume is unintended;

5) general trust law would apply to the scheme proposed, and there is considerable debate about the implications that this will have in the market; and

6) as a result, there is a real concern that financiers could become responsible for payments already made.

Should you wish to discuss this letter please contact either me or Alison Tierney, AFC Corporate Lawyer, on telephone 9231 5877, fax 9232 5647 or e-mail afc@afc.asn.au

Yours sincerely

STEVE EDWARDS
Associate Director Legal

Attachment:
- AFC Member list

AFC MEMBER COMPANIES

12/97

Adelaide Bank
Advance Bank
Asset Risk Management
AT&T Capital
Australian Guarantee Corporation
Automotive Financial Services
Avco Access
Avco Financial Services
Bank of Melbourne
BankWest
BMW Australia Finance
Bridge Wholesale Acceptance Corporation
Capital Corporate Finance
Caterpillar Financial Australia
CBFC
Elderslie Finance Corporation
Esanda Finance Corporation
FAI Finance
GE Capital
General Motors Acceptance Corporation
GIO Finance
HDFI
Heller Financial Services
Heritage Building Society
John Deere Credit
Land Rover Finance
Medical Equipment Credit
Mercedes Benz Finance
Motorcharge Finance
Newcourt Credit
Nissan Finance Corporation
NRMA Finance
ORIX Australia Corporation
PIBA Equipment Finance
RAC Finance
R.A.C.V. Finance
Rental and Finance Limited
Select Automotive Finance
St. George Bank
Suncorp-Metway Limited
Textron Financial
THLC Finance
Toyota Finance Australia
Volvo Finance Australia
Westlawn Investment Company

Document 10

Institute of Chartered Accountants

Correspondence on amendments to the Contractors Debts Bill

Room 937
Parliament House
Macquarie Street
SYDNEY NSW 2000
Tel: (02) 9230 2363
Fax: (02) 9230 3052

JOINT STANDING COMMITTEE UPON SMALL BUSINESS

Mr Jim Malins
Government Liaison Services
Institute of Chartered Accountants
Level 9, 37 York St
Sydney NSW 2000

18 March 1998

Dear Mr Malins

Re Independent assistance with the interpretation of a proposed Legislative amendment.

The Joint Standing Committee upon Small Business is currently investigating options to improve the security of payments to building sub-contractors.

One of the options proposed to the Committee is an amendment to the Contractors Debts Bill, which would introduce a concept of cascading deemed trusts through the payment chain from the Owners/ financiers down through the layers of sub-contractors and material suppliers. A copy of this amendment is attached as Appendix 1.

A by-products of this amendment and of the introduction of the concept of deemed trusts is that it would change the priority of claimants in the event of a bankruptcy or liquidation. The proponents and opponents of this amendment have provided the Committee with considerably divergent opinions on the way the proposed legislation will impact on the both normal commercial operations and on any liquidation process.

My purpose in contacting the Institute at this time is to determine if the Institute could provide the Committee with some expert but independent commentary on the likely impact of the proposed amendment in the case of head contractor insolvency.

As a further step advice may be needed on fine tuning of the proposal if the Committee decides that the amendment has further potential and may be incorporated in the Committee's recommendations to Parliament; but this aspect is still in the future.

A recent interchange of correspondence between the Mr I Gilbert from the Australian Bankers' Association and Mr P Davenport on behalf of the Construction Payments Group, who are supporting this amendment, summarises the positions which are being put to the Committee and these letters are attached for your information as Appendix 2.

If you are able to assist the Committee on this matter I would be grateful if you could contact me on 9230 3052.

Yours sincerely

G. Cepak

George Cepak
Director

The Institute of
Chartered Accountants
in Australia

14 April 1998

Mr George Cepak
Director
Joint Standing Committee Upon Small Business
Parliament of New South Wales
Fax: 9230 3052

Dear Mr Cepak,

I refer to our meeting on Thursday 2nd April 1998 when I agreed to write, confirming the remarks I made to you with regard to the proposed amendments to the Contractors Debts Bill.

Preliminary
Before dealing with specific clauses I should mention my views about the main thrust of the amendments, being to create a trust fund for sub contractors.

If the principal has paid a sum of money to the contractor and, contrary to the proposed amendments, the contractor has used those funds, then whilst there might be an action which could be taken against the contractor for breach of trust, where the contractor has no assets, it would seem to me that the sub contractors would have no means of receiving payment. Further, suppose the principal made a payment to the contractor and the contractor drew the money out but deposited other funds into the account, then I believe that the trust would have already been broken and the new monies could not be claimed as part of the original trust fund.

Comment on specific clauses
Sub clause 14 (3): This would appear to preclude the contractor from drawing, from progress payments, his own profit percentage of the progress claim, if for instance, there is a dispute with one of the sub contractors for faulty work which has arisen after the progress claim has been lodged with and paid by the principal.

Clause 17: By issuing a demand, a sub contractor could obtain information about payments to other sub contractors. It would seem that this could create a problem regarding confidentiality.

Effect on Priorities
I now deal with the effect of the proposed amendments on the priority of debts due to employees of the contractor in the event of the contractor going into liquidation or being declared bankrupt, as the case may be. If the amendments work as intended and there are funds from which sub contractors can be paid either in the form of monies which can be traced in a bank account or book debts due to the contractor by principals, then these monies would most likely be the major assets of the contractor. Therefore the only other assets available for the payment of other creditors, in accordance with the priority set out in Section 556 of Corporations Law or Section 109 of the Bankruptcy Act 1966, would be any cash not subject to the sub contractors trust fund and such other items as plant and equipment. In my experience realisations from such other assets would not produce a large sum of money and

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therefore it is quite likely that there would be no funds available for payment of the contractor's other employees in the event of insolvency. Thus there could be anomalous situations where one group of the contractor's employees could be paid because a trust fund existed from a recent project, whereas the rest of the contractor's employees remain unpaid. Clearly, all other creditors further down the list of priorities would also miss out.

Please do not hesitate to contact me if you need clarification or further comment on any of the issues that I have raised.

Yours sincerely,

David Blackwell

David Blackwell

Document 11
Advising from Crown Solicitor's Office

Correspondence re: Legislative proposal for security of payments - building sub-contractors

Crown Solicitor's Office

NEW SOUTH WALES

Your ref:
My ref: PAH119.56
T2 Ms Corneliusen

Tel: (02) 9224 5050
Fax: (02) 9224 5055

1 April 1998

Mr George Cepak
Room 937
Parliament House
Macquarie Street
SYDNEY NSW 2000

Dear Mr Cepak,

RE: LEGISLATIVE PROPOSAL FOR SECURITY OF PAYMENTS-BUILDING SUB-CONTRACTORS

I refer to your instructions in this matter, undated, but received in this office on 16 March, 1998.

1. **Background**

1.1 Security of payment for sub-contractors, and others in the construction chain, is an issue which has been under consideration since the 1991 Royal Commission into the Building Industry.

1.2 Debate between parties interested in the issue has continued since approximately 1992 and you have kindly provided me with a large volume of material by way of background to this matter.

1.3 I have referred only to the documents to which you direct me in your request for advice. I have not re-stated the views of the parties and have referred to those views only in the broadest terms.

1.4 The material you provide includes:-

(i) report by Coopers and Lybrand dated August 1996;

(ii) proposal of the Construction Payments Group;

(iii) comments by Clayton Utz on the Draft Amendments to the Contractors Debts Bill relating to Statutory Trusts and

(iv) response, by Mr. Phillip Davenport, to the comments of Clayton Utz.

2. **Advice Sought**

In seeking advice, you raise the following questions:-

2.1 *"Do any of the concerns raised in the Coopers and Lybrand Report August 1996 ("C&L") about the SOPC Proposal still have any relevance or impact on the revised proposal put forward by Construction Payments Group ("CPG") in Appendix 2"*

I understand from our telephone discussion today, that the advice you seek is whether the difficulties which C&L regarded as inherent in the earlier SOPC proposal have been addressed by CPG's revised proposal and its proposed revised wording of the legislation.

C&L concerns were basically that the SOPC proposal was not viable in terms of:-

(a) industry issues, in relation to the effect on cash flows, ability to raise finance and increased cost of administration by a trustee;

(b) legal issues, especially in relation to identification of trust moneys; duties of trustees, priority issues and inconsistency with Commonwealth Legislation;

(c) commercial issues, including the potential for the proposal to complicate arms' length relationships and the effect on the financial system in terms of the increased likelihood of financiers being fixed with constructive trusteeship;

(d) practical issues, given that every entity in the construction chain would become a trustee for the entity below it in the chain.

The CPG comments to which you refer me consists of 10 points and includes a revised wording of the legislation. It does not, in my view provide a solution to the difficulties raised by C&L.

2.1 *"Have all of the concerns raised in the Clayton Utz opinion of February 1998 been fully answered by the Davenport 29-page response, or are there any matters which would make the operation of the proposed amendment inadvisable or unviable in NSW?"*

The issues raised by Clayton Utz basically are basically the same as those raised on by C&L although that Clayton Utz have also addressed what it sees as serious deficiencies in the legislation, in terms of definitional problems, uncertainty arising from the legislation and consequently the potential for litigation.

Mr. Davenport is of the view that by small amendments to the draft legislation the difficulties raised by Clayton Utz can be overcome, especially in light of the fact that a statutory scheme similar to the one under discussion operates successfully in Canada. A comparison between the construction industry in Australia and that in Canada as well as a comparison between the legislation there and the proposed legislation now being considered might need to be made, and I understand that the Committee's researchers are obtaining material on this point.

Contrary to the view of Mr. Davenport, I am of the view that the proposed scheme presents very real difficulties in relation to the general law of trusts. It would be different if the legislation was intended as a code, which would operate independently of the law of trusts, but this is not a possibility while there are such major policy issues inherent in the proposal. The most significant of these being (i) the potential to disturb the order of priority of employees and secured creditors and (ii) the potential

effect on the conduct of commerce, banking and contractual relationships. Resolution of these policy issues is, of course, beyond the scope of this Office's brief.

2.3 *"In particular, could the proposed amendment operate in NSW with "deemed trust moneys" intermingled with other business cash flows of a contractor without the use of a separate "Trust Account"?"*

The use of a separate "Trust Account" may overcome some of the legal problems in terms of established trust principles. The operation and administration of a "deemed trust" cuts across two important trust principals, the first of which is the principle that trust moneys may not be mixed with non-trust moneys and the second of which is the principle that beneficiaries of the trust must be identifiable. In the construction chain, particularly on a large project, there could be a large number of 'trustees', and beneficiaries. Each entity in the chain would be a trustee for the entity below it in the chain and the further down the chain one goes, and as the amounts of 'trust money' become smaller, it becomes less likely that these basic trust principles will be, or could be, adhered to. There is no contractual relationship between an entity down the chain and the entity two or more places higher up the chain, therefore the entity down the chain does not have any contractual remedy against the entity higher up the chain. In addition, an entity down the chain, particularly towards the bottom the chain, would probably not be inclined to resort to equitable remedy of tracing trust funds to which it is entitled up through the chain. These considerations lead me to the view that while the principle underlying the proposed scheme is one of fairness, the implementation of the scheme by the legislation proposed is not free of difficulty.

While the 'deemed trust" could work, it would be very complex and may require amendment to Commonwealth legislation, which may not be politically acceptable.

2.4 *"Is the Clayton Utz assessment that a separate trust fund would be required by a contractor for each improvement correct, and if not, is Mr. Davenport's opinion that all that is needed is separate records of each contract to be maintained by the Contractor accurate?"*

In order to satisfy general trust principles, two of which I have been referred to above, a contractor or supplier in the chain, who becomes a trustee, is required to keep trust moneys and general moneys in separate accounts. If the 'trustee' is required only to keep separate records of each contract rather than a separate trust account, the potential for exposure by banks to constructive trusteeships is very real. If a 'trustee' does not keep a separate trust account in respect of each contract it is difficult to see how the beneficiaries of that trust could be identified. In the opinion of Mr Roger Gyles QC under the proposed legislation contractors could be required to keep separate Trust Accounts in the same way as Solicitors and Real Estate Agents are required to. Even these in practice cause difficulties.

3. Conclusion

In my opinion there are inherent legal and policy difficulties with the proposed scheme, the most significant of which is the issue of priority as between sub-contractor beneficiaries on the one hand and employees and creditors of the contractor on the other hand. This difficulty could be overcome by the enactment of parallel Commonwealth legislation. The effect which the proposed legislation will have on the law of contract and the exposure of banks to liability arising from constructive trusteeships are also issues of policy which need to be resolved before the proposed scheme can be brought to fruition.

Yours faithfully

Lyn Corneliusen

Lyn Corneliusen
Solicitor
for Crown Solicitor