

31 August 2018

Security of Payment: Consultation Paper
Department of Finance Services and Innovation
Regulatory Policy Branch
LISAROW NSW 2252

By Email: security_of_payment2018@finance.nsw.gov.au

Dear Sirs

Submission about a Proposal for 'Deemed' Statutory Trusts to Secure Payments in the Building and Construction Industry

Introduction

1. The NSW Government, through the Department of Finance Services and Innovation, has called for public submissions about a proposal for the imposition of deemed statutory trust on revenues of contractors in the building and construction industry.
2. This submission is made by Kreisson.
3. Kreisson has been providing legal services to builders, owners and other participants in the building and construction industry for over ten years
4. Our lawyers have many more years experience providing legal services to the construction industry, either as consultants or as inhouse advisers.
5. Kreisson has been involved in numerous adjudications, as well as court and tribunal proceedings, about security of payment claims in most Australian jurisdictions.
6. We are therefore well placed to provide considered opinions about the questions raised in the consultation paper.

Overview

7. The *Building and Construction Industry Security of Payment Act 1999* has been in effect since 2000.
8. It is modelled loosely on UK legislation.
9. The New South Wales version of the legislation has been the basis of similar enactments in Victoria, Queensland, Tasmania and South Australia. That legislation follows what is known as the “East Coast Model”.
10. The East Coast Model is primarily designed to secure cash-flows, with severe consequences if the parties do not comply with strict timetables. It provides a statutory right which operates in parallel to any contractual rights to regular progress payments.
11. Western Australia and the Northern Territory have adopted a substantially different legislative scheme, known as the “West Coast Model”.
12. That model provides an evaluative system which is focused on providing speedy determinations of contractual rights.

The Legislative Object

13. The objective of the *Act* is to ensure that anyone who carries out construction work or supplies goods and services to construction projects is entitled to receive regular progress payments.
14. The *Act* creates a statutory entitlement to regular progress payments, whether or not the parties have agreed to such a payment regime.
15. Progress payments may be recovered by a quick and dirty procedure that involves
 - a. the contractor lodging a payment claim
 - b. the principal responding promptly with a payment schedule, setting what parts of the claim are accepted and what parts are disputed;



- c. absent a payment schedule, the contractor having an immediate right to payment of the amount claimed;
- d. a claimant referring a disputed claim to adjudication;
- e. an adjudicator who is independent of the parties being appointed;
- f. the parties making submissions to the adjudicator within an abridged timeframe;
- g. the adjudicator making a quick determination;
- h. that decision being enforceable in the same way as if it a judicial determination;
- i. the parties reserving the right to refer their dispute to a Court in the ordinary way, within being estopped by *res judicata*.

The Problem

- 16. There is a high rate of insolvency within the building and construction industry.
- 17. In the context of an enquiry into the incidence of insolvency in the Australian construction industry, the Senate Economic References Committee expressed the view that anyone performing work under contract should be paid without delay. Remarkably, no-one on the Committee had any background in the building and construction industry or company reconstruction.
- 18. The Minister for Employment subsequently commissioned Mr John Murray AM
 - a. to review security of payment legislation;
 - b. to take into account the views of the Senate Economic References Committee as well as the findings of the 2003 Cole Royal Commission and other relevant reviews,
 - c. to consult with business, governments, unions and interested parties, and



- d. to consider contractual arrangements that work to restrict construction contractors obtaining payment.
19. Mr Murray did not submit the issues to general public consultation. Instead, he interviewed industry representatives from trade unions, trade associations, regulators and academia as well as some legal practitioners and adjudicators.

The Proposal

20. Mr Murray discovered:
- a. the construction industry has a pyramidal structure,
 - b. head contractors seek to pass risks to subcontractors,
 - c. head-contracts and subcontracts are usually back-to-back,
 - d. subcontractors lack the bargaining power to negotiate more favourable provisions,
 - e. subcontractors are vulnerable to late payment and
 - f. subcontractors are vulnerable to insolvency risks.
21. He expressed the opinion that “... *the most effective way that payments can be secured from misuse and the risk of head contractor insolvency is by implementing a cascading statutory trust. Only such a statutory trust would secure the payment of all subcontractors, including the most vulnerable at the base of the contractual chain*”.
22. Mr Murray recommended that a “*deemed statutory trust model should apply to all parts of the contractual payment chain for construction projects over \$1 million.*”
23. He proposed that the “*model outlined in the Collins Inquiry provides a suitable basis*”
24. He urged all Australian Governments to work towards a nationally consistent model.



Public Consultation

25. The NSW Government proposes to legislate for a trust to bind the revenues of contractors in the building and construction industry
26. The Government considers that the proposal will provide greater protection for subcontractors.
27. The effect of the proposal will be to allow subcontractors in the building and construction industry debts to recover debts in priority to other creditors, whether they are secured, preferred and unsecured.
28. Usually, after secured debts are discharged, the costs of the winding up are paid first, then employee entitlements, then unsecured creditors, then shareholders¹. Within each rank, debts are paid equally and to the extent that the company has insufficient assets to meet those debts, the loss is borne proportionately.
29. The proposal will allow subcontractors to leapfrog everyone else and call on the cash assets of a building company in liquidation.

Our Submission

30. Our submission examines the legal, practical and economic aspects of the proposal.
31. In our view, the proposal is based on false precepts that:
 - a. participants in the construction industry repose some special kind of trust and confidence in each other and don't transact business on an arms-length commercial basis,
 - b. there is some special imperative to protect subcontractors in the construction industry;
 - c. federal insolvency laws should not apply to construction contractors;
 - d. building subcontractors should be paid in priority to employees and other creditors.



32. In our submission, the proposal is misconceived and ought be rejected.

A fiduciary relationship?

33. The proposal calls for a statutory imposition of a fiduciary obligation on the contractor, irrespective of the arrangements struck with its subcontractors or the circumstances of either party.
34. In the usual case, a fiduciary relationship exists where one imposes especial trust and confidence in another. The critical feature is the fiduciary undertakes to act for and on behalf of, or in the best interests of, another in a representative capacity and in doing so, places the other's interests ahead of its own,
35. The fundamental question is one of intention; for what purpose and for the promotion of whose interests is money received and held? The distinguishing element is that the money was received in order to serve the interest of another person or group of persons in circumstances where it is plain that the trustee is not free to pursue its own interests.
36. A fiduciary relationship exists where one person reposes trust in another to act in the former's best interests to the exclusion of the latter's self-interest. The correct approach is to discover whether the fiduciary undertakes or agrees to act in the interests of another in a legal or practical sense and in doing so, adopts a 'representative' character². That sort of relationship should be protected, so that the fiduciary does not abuse its position at the cost of its principal.
37. There are two jurisprudential theories about the nature of the relationship. They look at the issue from opposite perspectives. "Entrustment" theory is approached from the viewpoint of the principal and posits that a fiduciary relationship should arise if one person reposes particular trust and confidence in another. On the other hand, "undertaking" theory is considered from the perspective of a fiduciary who has undertaken to protect another's interests.
38. There are a number of well-recognised relationships which are commonly presumed to give rise to fiduciary obligations. For example, company directors must put the company's interests first. Solicitors owe loyalty to their clients. Business partners have



to look out for each other's interests. But, in most cases, one has to look at the particular facts and relationship to say whether one person has a fiduciary responsibility to another.

39. The proposal fundamentally mis-conceives how subcontractors on building projects are engaged and administered. No-one can sensibly suggest that subcontractors repose such trust and confidence in contractors as to expect them to pursue the former's interests to the exclusion of their own. Contractors will be surprised to learn that they have somehow subordinated their own commercial interests to those of their subcontractors. Their relationship is a strictly commercial arrangement reached at arms-length, often by a tender process. Subcontractors are engaged to achieve a result in specialist trades work. Their relationship is contractual, not fiduciary.

Vulnerability

40. At the core of the proposal is the assumption that subcontractors are vulnerable and unable to protect their own interests.
41. Mr. Murray opined that the "*hierarchical contractual chain leaves subcontractors not only vulnerable to the consequences of late payment (and therefore having to draw on their own sources of finance, such as overdraft facilities to meet payment obligations to suppliers and their employees) but also the risk of insolvency of parties higher up the pyramid*"
42. But vulnerability is not the touchstone of fiduciary obligation.
43. It is simplistic and incorrect to claim that vulnerable persons are owed fiduciary duties. Ascendancy, dominance, undue influence, financial dependence, weakness of mind or faintness of will are relevant factors, but only to the extent that they indicate the degree of trust reposed by one in another. There are many relationships where negotiating power is far from equal but there is no fiduciary obligation, such as doctor and patient; priest and penitent; regulatory authority and citizen; banker and customer; insurer and insured, tax collector and taxpayer. The 'vulnerability' test has been authoritatively debunked³.



44. Nor is it true that all subcontractors are commercially vulnerable. Listed companies like Adelaide Brighton Ltd, Brickworks Ltd, Boral Limited, Bluescope Steel, CSR Limited, Fletcher Building Limited Holcim and James Hardie Industries PLC and DowDuPont are major suppliers to the construction industry. Heavy hitters like CIMIC, Lend Lease Building Pty Ltd, CPB Contractors, General Electric, Laing O'Rourke, Kawasaki Heavy Industries, Mondelphous, Spotless and UGL are all willing to take positions as subcontractors in many projects. Design consultants like Aecom, Arup, Aurecon, Alstom, and Woods Bagot all provide related services and are ready to take advantage of the security of payment legislation.
45. The proposal also falls into error by superimposing a fiduciary obligation simply to improve the nature or range of remedies available to subcontractors in the course of a commercial dispute⁴.

Fiduciary obligations

46. The consultation paper demonstrates a narrow understanding of fiduciary duties and equitable remedies. It's therefore instructive to identify the full range of those duties.
47. A trustee is not free to pursue its own interests. Instead, it is obliged:
- a. to ensure its self-interests do not come into conflict with those of the beneficiary;
 - b. not to keep for itself, nor divert to anyone else, any interest or other profit that may be derived from trust money but instead to account to the beneficiary;
 - c. to preserve trust money, if necessary; by taking or defending legal proceedings;
 - d. to invest trust money⁵;
 - e. to deal with trust money exclusively for the benefit of beneficiaries, even to the exclusion of its own interests.
 - f. to keep and render proper accounts and allow inspection of the accounts;



- g. to act personally⁶ and not delegate the administration of trust money to anyone else, except to the extent allowed by statute⁷ or as a matter of necessity;
- h. to act impartially so that any shortfall is shared equally by all beneficiaries;
- i. to insure trust money against forgery, embezzlement, misappropriation and other frauds;
- j. to seek the direction of the Court about proper investment, application and distribution of trust money⁸
- k. to be exonerated or indemnified for the costs and expenses of administration directly out of the trust money;
- l. to be reimbursed for those costs and expenses by the beneficiaries personally;
- m. to act prudently⁹;
- n. to pay trust money on demand by a beneficiary even if payment is not yet due and
- o. to distribute trust money to a trustee company or the NSW Trustee if a beneficiary cannot be found.

Unintended consequences

- 48. Where a fiduciary obligation arises in a contractual context, the obligations of a trustee must accommodate the terms of that contract so they are mutually consistent. Presumably, the statute will say that any contrary agreement between a contractor and subcontractor is void.
- 49. Given the range of trustee's duties, it's inevitable that the legislative proposal will have unintended consequences.
- 50. For example, a trustee's creditors are entitled to be subrogated to the rights of exoneration and reimbursement, so that they may have recourse either to the trust



money or to the beneficiaries personally. The proposed statutory scheme will be ineffective unless those rights are overridden.

51. It's difficult to believe that the Government intends to impose liability on honest and well-meaning contractors who disburse funds to subcontractors in the order that they submit payment claims. But a contractor impressed with a deemed statutory trust will be liable for any loss if it is left with insufficient funds to ensure that shortfalls are shared equally by all beneficiaries.
52. The obligation to distribute available funds *pari passu* will inevitably lead to payments to all subcontractors being delayed until the outcome of any adjudication or curial contest about the amount owed to any one of them is known.
53. In the ordinary course, the directors of a trustee are not responsible to make good any loss of trust money out of their personal assets, unless the proceeds can be traced into their hands. The proposal for accessorial liability will require company directors to make good payments to subcontractors out of their own resources.
54. It is well established that beneficiaries who are absolutely entitled to trust money can call for its immediate distribution, even though it is not yet due for payment¹⁰. Subcontractors will therefore be able to demand payment immediately after the funds come into the contractors hands, even though payment is not yet due under either the contract or the *Act*.

The Economic Dimension

55. The basis of insolvency law is the inability to pay debts. It reflects *every creditor's primary concern in commercial transactions, namely; to receive payment when it falls due*. That concern is not unique to the building and construction industry. It applies just as much to the retail and wholesale trades, professional services, technology sectors, personal services and other industries. Business and personal services businesses are more likely to come under external administration than businesses in the construction trades¹¹.



56. The same arguments in favour of deemed statutory trusts could be equally applied to all small businesses, not just in the construction trades. Mr. Murray has not explained why a trades suppliers should be preferred over other suppliers. Is there any reason to ensure the architect is paid, but not the accountant who provides services to the same builder?
57. Insolvency is as often attributable to poor strategic management as high cash use or inadequate cash flows¹². Poor financial control and record keeping is also a common cause of business failure.
58. There is a persuasive argument that Government ought not allow companies to escape the consequences of their contracts, even if they are hard bargains. It leads to what economists call “moral hazard”, that is; a reduced aversion to risk.
59. The judicial arm of Government will not do so, as “*it is ordinarily no part of equity's function to allow those who do make such bargains to escape from them*”¹³. The High Court has said there is no good reason to relieve traders from poor commercial decisions if they are able to judge where their best interests lie, notwithstanding any disparity of bargaining power. Justice Kirby (undoubtedly, a social progressive) thought to do so would be to drive a “*herd of elephants through the marketplace*”.
60. The Productivity Commission has emphasised the important economic role performed by the insolvency system¹⁴. It facilitates orderly business exits in a way that provides certainty to creditors and prevents a competitive scramble for recovery. It also provides genuine opportunities for viable companies to restructure.
61. Its judgment is that Australia’s insolvency laws work relatively well and do not require wholesale change. Reform should be directed at refining the timing and effectiveness of debt restructures and refining the process of liquidation so that it is inexpensive and expedient. Recent amendments *to the Corporations Act 2001* provided a safe harbour for directors who trade whilst insolvent in order to achieve a better outcome than external administration as well as preventing valuable contracts being terminated ipso facto an external administration.



Our Responses

62. Do you support the proposal to establish deemed statutory trusts in the Act?

No

63. What alternative reform(s) could be implemented?

The statute might allow an assignment of the principals' debt to the contractor to be effected simply by giving notice of an adjudication determination favouring the subcontractor. Div 4 of the Building and Construction Industry Security of Payment Act 2002 (Vic) provides a workable model. It can be improved by omitting the requirement to first register an adjudication determination in a Court of competent jurisdiction.

64. Do you support the proposal to apply a cascading 'deemed' statutory trust model?

No

65. What would be an appropriate point in the contractual chain to limit the requirement for 'deemed' statutory trusts?

A trust should not be imposed on contract payments at any point in the contractual chain.

66. Do you support the proposal to apply the requirement for 'deemed' trusts to construction projects valued at \$1 million or more?

A trust should not be imposed on contract payments, regardless of the contract value.

67. What would be an appropriate alternative monetary threshold?

A trust should not be imposed on contract payments, regardless of the contract value.

68. Do you support the proposal to limit the application of the requirement to parties based on the value of their individual contracts?

No. A trust should not be imposed on contract payments, regardless of the contract value.

69. What would be an appropriate contract value?

A trust should not be imposed on contract payments, regardless of the contract value.

70. Do you support the proposal that the requirement for a deemed trust should arise immediately when the contract monies are received by the trustee?

No. A trust should not be imposed on contract payments at any stage.



71. What would be an appropriate point in the contract lifecycle for the deemed statutory trust to be established?

A trust should not be imposed on contract payments at any stage.

72. Do you support the proposal that responsibility for managing 'deemed' trust monies is placed on the trustee?

No. Statutory intervention is unwarranted. It is well established that a trustee must act personally in the management of trust assets¹⁵.

73. Do you support the proposal to allow trust monies on multiple construction projects to be held in a consolidated trust account?

Yes. It is a generally accepted accounting practice to record trust transactions in discrete ledger accounts.

74. Should there be any further obligations applied to trustees and/or beneficiaries to support the efficient flow of monies in/out of accounts (for example, a requirement for transaction certificates of some form)?

This is merely a matter of book-keeping practice and does not address the fundamental obligations of a trustee.

75. Do you support the proposal to not require auditing of trust records?

Yes. Although a trustee is obliged to keep proper accounts, it is not ordinarily obliged to have those accounts externally audited.

76. Do you consider that the compliance and enforcement powers proposed in the exposure draft Bill are sufficient to support the operation of 'deemed' statutory trusts?

Statutory intervention is unwarranted. There are a wide range of well-settled equitable remedies for breaches of trust.

77. What type of compliance and enforcement powers or framework would be preferred?

Statutory intervention is unwarranted. There is a wide range of well-settled equitable remedies for breaches of trust.

78. Do you support the proposal to allow the trustee to withdraw funds from the account before a subcontractor has been paid?

A trust should not be imposed on contract payments. A contractor should have full beneficial use and enjoyment of its own revenues.



79. When should a trustee be permitted to withdraw funds?

A trust should not be imposed on contract payments. A contractor should have full beneficial use and enjoyment of its own revenues.

80. Do you support the proposal to allow funds to be distributed on a pro rata basis as a proportion of their payment claims?

Statutory intervention is unwarranted. It is well established that any shortfall in trust assets must be shared by the beneficiaries equally. Aequalitas est quasi equitas.

81. What other model of distribution would be preferred?

Statutory intervention is unwarranted. There is no reason to change a long-established principle of Equity.

82. Do you support the proposal relying on the existing dispute resolution mechanisms in the Act?

Adjudicators from engineering, quantity surveying or construction disciplines will not be familiar with fiduciary duties, trusts and remedies in Equity.

83. Are any new or amended mechanisms required?

No. Statutory intervention is unwarranted. There are well-settled remedies in Equity for breaches of trust.

84. Do you support the proposal to allow the investment of 'deemed' statutory trust monies?

It is a well-established obligation that trust monies should be invested¹⁶.

85. Are any further provisions necessary to support the operation of this proposal?

No. There are well-settled obligations in Equity. Statutory intervention is unwarranted.

86. Do you support the proposal to allow the beneficiaries to inspect the records of 'deemed' trust accounts?

Statutory intervention is unwarranted. It is a well-established obligation that beneficiaries have a right to inspect a trustee's books of account.

87. Is there an alternative approach that would provide beneficiaries with a similar degree of awareness?

Statutory intervention is unwarranted. It is a well-established obligation that beneficiaries have a right to inspect a trustee's books of account.



88. Do you support the proposal to apply executive liability to directors and other relevant persons for breaches?

No. The objective of the Act (expressed in section 3) is to provide entitlement to regular progress payments in a particular commercial context. The proposal does not assist that objective. Accessorial liability should not be applied unless there is a wider public interest, such as taxation, WHS, and environmental offences.

If the proposal for deemed statutory trusts is adopted, statutory provision will be redundant as directors who knowingly assist a breach of fiduciary duty will be liable to the unpaid subcontractor by virtue of the rule in Barnes v Addy¹⁷.

The role of directors is to ensure governance, provide strategic direction and monitor culture and performance. They delegate the execution of policy to others. Directors are not personally involved in paying accounts except in the smallest micro-businesses.

Adequate mechanisms exist to claw back money from directors who permit a company to trade whilst insolvent (subject to safe harbour exceptions) or divert corporate funds improperly. Otherwise there is no warrant for piercing the corporate veil.

The proposal involves an onerous regulatory burden. It will oblige corporations to implement stringent internal procedures and require supervision of third parties. For example, it will require companies to provide information, training, instruction and supervision to contractors about topics like the accuracy of supporting statement and retention money trust requirements.

89. A Workable Alternative

90. In our opinion, a better solution would be a statutory assignment of the contractor's right to recover payment from its principal.
91. It could be effected simply by a subcontractor providing the principal with a simple demand corroborated by a copy of an adjudication determination against the contractor.
92. Payment of the debt to the subcontractor would discharge the principal's obligation to its contractor. A principal faced with multiple statutory assignments would simply pay



them in order of receipt, until its debt is exhausted. In the event that the principal is placed in external administration, then subcontractors can lodge proofs of debt in the ordinary way.

93. Div 4 of the *Building and Construction Industry Security of Payment Act 2002* (Vic) provides a workable model but can be improved by omitting the requirement to first register an adjudication determination in a Court of competent jurisdiction.
94. Our proposal provides a cheaper, faster and simpler remedy than the process allowed by the *Contractors Debts Act 1997*. That legislation requires a subcontractor to take Court proceedings to recover money owed for construction work or materials or, alternatively, to register an adjudicator's determination with a Court. In either case, an application has to be made to a Court for the issue of a "debt certificate". The statute also requires a demand to be in a prescribed form. Those procedural complications add nothing to the judgement or determination and are administrative barriers to the timely recovery of progress claims.
95. The proposal is supplementary to the withholding obligations mandated by Division 2A of the Act withholding request. That process prevents a principal making early payment to a contractor until an adjudication application is determined.
96. We would be happy to work with the Department to draft legislation to give effect to this alternative solution.

Yours sincerely,

KREISSON



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- 1 *Corporations Act 2001* s.556(1)
- 2 *Hospital Products v United States Surgical Corp* (1984) 156 CLR 41 per Mason J
- 3 *John Alexander's Clubs Pty Ltd v White City Tennis Club* [2010] HCA 19.
- 4 *Breen v Williams* (1996) 186 CLR 71 at 10
- 5 *Wharton v Masterton* [1895] AC 186 at 197
- 6 *Flower v Metropolitan Board of Works* (1884) 27 Ch. D. 592
- 7 specifically, *Trustee Act 1925*, s.53
- 8 *Ibid.* s.86
- 9 *Ibid.* s.14);
- 10 *Saunders v Vautier* (1841) 4 Beac.115.
- 11 ASIC, *Insolvency Statistics: External Administrators Reports* (July 2016 to June 2017)
- 12 *Ibid.*
- 13 *Clarion Ltd -v- National Provident Institution* [2000] 1 WLR 1888
- 14 Productivity Commission, Inquiry report 75, “*Business Set-up, Transfer and Closure*”, 30/9/2015.
- 15 *Flower v Metropolitan Board of Works* (*supra*)
- 16 *Wharton v Masterman* (*supra*)
- 17 (1874) LR 9 Ch App 244

